

**Joint Legislative Study
Committee on Internet
Privacy, Jurisdiction,
Regulation, and Taxation
(Internet Study Committee)**

***Positioning Arizona to
Achieve Maximum Benefit
from the Information
Economy: Final Report***

December 1, 1999

Accession number: LSC99_9

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**Arizona Legislature
Joint Legislative Study Committee
on Internet Privacy, Jurisdiction,
Regulation & Taxation**



Positioning Arizona to Achieve Maximum Benefit from the Information Economy

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FINAL REPORT

STATE DOCUMENTS

Submitted to the Governor & Legislature
As required by Laws 1999, Chapter 264
December 1, 1999

Committee Members:

Representative Jeff Hatch-Miller
Representative Barbara Leff
Representative Debora Norris
Representative Ramon Valadez
Representative Barry Wong

Senator Ken Bennett
Senator Scott Bundgaard
Senator George Cunningham
Senator Harry Mitchell
Senator Marc Spitzer

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December 1, 1999

The Honorable Jane D. Hull
Governor, State of Arizona

The Honorable Brenda Burns
Arizona State Senate President

The Honorable Jeff Groscost
Speaker, Arizona House of Representatives

Dear Governor Hull, President Burns & Speaker Groscost:

Laws 1999, Chapter 264 (HB 2639) established the Joint Legislative Study Committee on Internet Privacy, Jurisdiction, Regulation and Taxation. The committee was charged with studying Internet issues and issuing a report to the Governor and Legislature by December 1, 1999. The attached report was prepared to comply with the provisions of Laws 1999, Chapter 264.

This report provides a broad range of information on Internet issues categorized into six main focus areas: Security, Infrastructure, Regulation, Jurisdiction, Taxation, and Privacy. Working in subcommittees and with different stakeholders, the Committee developed principle statements for each of the focus areas that can act as policy guides for future legislation in these areas.

As chairman of the Committee, I would like to thank the members of the Committee for their diligent work and participation on the Committee. I would also like to recognize the number of public citizens and stakeholders that came before the Committee to testify and provide input on this very important and evolving issue. It has been a pleasure working on this issue in the hopes of positioning Arizona to achieve the maximum benefit possible from the new information economy.

Sincerely,

Representative Jeff Hatch-Miller
Chairman
Joint Legislative Study Committee on the Internet

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Positioning Arizona to Achieve Maximum Benefit from the Information Economy

Laws 1999, Chapter 264, established the Joint Legislative Study Committee on Internet Issues. This legislation was passed to address the growing opportunities and challenges of living in "The Information Age." The Arizona Legislature recognized that state government has a role to play in taking advantage of the Internet's potential as well as forming defenses against cyber threats. Therefore, the Internet Study Committee was created to conduct hearings and to complete a report on issues surrounding Internet privacy, jurisdiction, regulation, taxation, electronic mail and twenty-first century communications systems. This report contains the findings and policy principles developed by the Committee.

The Internet Study Committee's membership included both Legislators and Governor appointed public and private sector members representing a diverse range of interests. The membership of the Committee was as follows:

Committee Members

Representative Jeff Hatch-Miller (chair)
Representative Barbara Leff
Representative Debora Norris
Representative Ramon Valadez
Representative Barry Wong

Senator Ken Bennett
Senator Scott Bundgaard (co-chair)
Senator George Cunningham
Senator Harry Mitchell
Senator Marc Spitzer

Mayor Chris Bavasi
Michelle Ahlmer
Peter Charlton
John Kelly
Dr. William E. Lewis
Michael McNulty

During the course of the Committee's study, seven areas of focus were established:

- ⇒ Jurisdiction
- ⇒ Regulation
- ⇒ Infrastructure
- ⇒ E-Government
- ⇒ Taxation
- ⇒ Security
- ⇒ Privacy

The Committee first conducted hearings to gather public testimony and input for each of the different focus areas. The Committee then formed subcommittees for the purpose of better understanding each focus area, identifying key issue components and formulating overarching principles for each. This report provides a summary of the Committee's findings and provides clarification of those important Internet issues that may significantly impact the state and require government involvement.

The process undertaken by the Committee has enabled members to gain valuable knowledge of this complicated subject. It is hoped that this report will broaden understanding of the topic for other Legislators and government officials, providing them with a reasoned foundation for use when facing public policy choices.

INTRODUCTION

In 1877 long parallel lines of steel entered Arizona, the first of many rails connecting the Territory to the rest of America and the world beyond. Towns that were fortunate enough to be alongside the railroad flourished. New, vigorous communities sprang up along its route. Those more

distant from the railroad withered, and many died, known in the present age only by historical reference.

In the 1990s new lines are entering Arizona. Made from fiber optic cable rather than steel, these lines transport data instead of locomotives and railcars. Yet, just as the days of the railroads, communities close to these lines of communication will likely prosper. Those more remote may not. These cables are the route by which the vast interconnected network of computers called the Internet provides everyone with a wider range of choices, increased opportunities and the power to communicate worldwide at the speed of light.

The printing press revolutionized the world by allowing the dissemination of information to the masses. The Internet brings this same information into everyone's home, school and office. In a matter of minutes a computer user can search through human history's treasure chest of accumulated knowledge.

In the classroom, the Web puts this treasure chest at every student's fingertips. Yet, to take advantage of it one must still learn how to access the information and, even more importantly, how to interpret it.

Impacts on the world of business are just as extensive. Entirely new pathways for businesses to communicate, conduct transactions and manage resources are in place. e-Tailers (Internet retailers) sell everything that can be shipped or downloaded. Wholesalers are trading everything from coal to computer components to cows. For example, Cisco Systems reports 80 percent of yearly sales come from its Web site. Intel recently announced that 50% of its chips are sold this way (all data circa 1999).

Forrester Research predicts that in less than four years (2003) the Internet may account for over \$3 trillion dollars in retail and business-to-business sales. The lions share (perhaps 80%) will be business to business transactions as marketing and ordering increasingly will be conducted via Internet based systems.

The impact may be substantial. Analyst Varda Lief of Forrester Research has determined that if just five percent of a supply chain shifts to doing mostly e-commerce, it will change the way of doing business in the entire industry.

The Internet has had and will continue to have a profound effect on all of our lives. Most of the change will be positive and beneficial. But as in every aspect of life, there are problems as well. The newness of the Internet means that only now is government truly seeing its potential, looking at the role of government, and attempting to tackle the complex issues of regulation, taxation and the like.

Some have argued that the Internet is so vast and so complex that only the Federal government can adequately regulate it. Others reason that the task is even too large for a nation, that only international bodies, and treaties, could manage it.

Yet the Internet is simultaneously global, regional and local. More than any other medium, the Internet is exceptionally personal in nature. All of its communications power depends on the projection of an electronic image on a single user's monitor and that user's deliberate response.

States, being closer to constituent concerns, are generally in a better position to identify constituent issues and respond to them. When someone is defrauded on the Internet they don't call the FBI or Congress, they call their local police. And almost all of

the types of concerns presented fall within traditional province of the states. Given these factors, it is not likely, nor appropriate, for states to cede authority over traditional turf in matters of consumer protection, liquor sales, medical licensing, crime, gambling, taxes, equal access, education – the list goes on and on.

To avoid a patchwork of laws, model legislation and interstate compacts may be required. In any event, states must assert their rights via a loud and meaningful presence in all decision making bodies.

The private sector, in conjunction with colleges and universities, have clearly been the major builder of the Internet. These results were obtained under minimal regulation. e-Industry (electronic industry) efforts to increase participation and bandwidth are succeeding. Protection of users from fraud and to secure their privacy have been numerous and generally successful. Powerful alliances of key e-industry representatives are now hard at work making the Internet the safest and preferred medium of all for selling, distributing, investing – for all the purposes possible over the Internet.

In its discussions the Committee has obtained many insights. From these insights have emerged principles that can be used to guide public policy debate.

Key Principles

1. *The Internet is a key element of the state's future economic, educational, health, safety, and government viability. The Internet infrastructure must be recognized as a fundamental component in the state's critical infrastructure.*
2. *A primary role of government is to protect citizens.*

3. *Electronic information should be made equal under law for the purposes of contract, evidence, or similar traditionally "paper based" uses. Arizona statutes should be revised as necessary to allow these electronic uses.*
4. *Though the private sector should exert primary leadership, government support for e-industry is essential for its success.*
5. *Government regulation should be employed when voluntary codes of conduct and industry self-regulation fail to provide an adequate remedy.*
6. *Providing special treatment to one sector of the economy, to the disadvantage of other competing sectors, does not make rational economic or tax policy. Government should provide uniform treatment for all. Requiring that sales and use taxes be collected on all like transactions is an equitable tax policy approach.*
7. *Alternative funding mechanisms are needed for the purpose of stimulating investment in less attractive communities and for early stage businesses.*
8. *e-Businesses (electronic businesses) have the ultimate power of choice as to where to locate. For Arizona to be successful in fostering e-industry development it must provide a political and economic climate that fosters continuing and increased investments in e-infrastructure (electronic infrastructure) and e-industry activities.*
9. *Arizona should tap all available external public and private funding sources earmarked for e-development to speed development during this critical infrastructure rollout phase.*
10. *The technology will certainly continue to evolve rapidly. What is true today,*

in terms of business alliances, market share, preferred method of transmission, and technical specifications, will likely not apply tomorrow. Any attempt to regulate e-industry must consider its evolutionary nature.

11. *Until viable alternative revenue sources are identified, existing tax structures should not be dismantled*

JURISDICTION

States are not free to govern everywhere. Territorial limits exist on their authority. These limits affect whom they may prosecute criminally, whom they may regulate and whom their citizens may sue in the state's courts. The general proposition is that the administrative powers of a jurisdiction are limited to the physical boundaries of that jurisdiction. Administrative bodies have been held to have no power to act officially beyond the limits of their territory. Yet, where does this territory exist in the borderless world of the Internet?

In the discussion on Jurisdiction, the Committee has identified two major components:

- Forum for Private Disputes
- Regulatory Authority

Forum for Private Disputes

If you pay for an item but never receive it, what court do you petition for redress? Throughout our history this question was generally defined by the physical boundary within which the transgression occurred. In the borderless world of the Internet, court jurisdiction is not as clear. Certainly individuals and organizations that believe they have been wronged have a right to ask for remedy in the appropriated court, but which one?

The Committee has identified one key principle in regard to the issue of providing a fair venue.

Jurisdiction Venue Principle

Arizona should provide a forum for its citizens to resolve disputes arising from Internet interactions to the greatest extent possible allowed by the Commerce Clause and principles of due process.

Regulatory Authority

Who should regulate the Internet? Various proponents have pointed to the state, others to the federal government, still others to an international treaty or governing body. Some industry spokesmen have asked that government keep "hands off," preferring to let the private sector self-regulate.

Under their police powers, states protect the health, safety and welfare of their citizens. Much of the activity on the Internet falls within the scope of these powers. States combat fraud, regulate the sale and administration of harmful products and substances, and protect the privacy of its citizens. The roles were envisioned by the founding fathers of the United States. Therefore, the states would appear to have a large role in continuing to regulate these types of conduct through the use of the Internet.

The Committee has identified the following principles for use when discussing regulatory authority.

Jurisdiction Regulatory Authority Principles

1. *Arizona has an interest in protecting the health and welfare of its citizens and in maintaining appropriate revenues. Beyond these areas*

government should let the market dictate.

- 2. Industry solutions and innovations should lead the way. Government should become involved when private solutions fail. An example of an industry solution is having a third party evaluate Internet merchants. A third party could survey consumers about the consumer's satisfaction with the transaction. The results would be reported free to consumers and merchants in a way that is easily accessible. Consumers could then identify unscrupulous or poor merchants.*
- 3. When Internet-based services replace traditional services, begin to deregulate the old rather than regulating the new.*
- 4. Efforts of the federal government to use the uncharted realm of the Internet to preempt state's rights should be challenged. Preference for local control should be the norm. The hierarchy of preferred solutions is first private, secondly local, thirdly state (including interstate compacts and reciprocity agreements), fourth federal, and finally international solutions.*
- 5. Those who use the Internet for business should be considered, prima facie, to be purposefully availing themselves of the privileges of the state in which the customer resides.*
- 6. The residence of the buyer should be considered the point-of-sale for all remote sales (e.g. Internet, telephonic, catalogue).*
- 7. All forms of remote sales should be treated uniformly.*
- 8. Regulators need to stay fully cognizant of actual and potential impacts on existing institutions and business practices.*

REGULATION

A fundamental role of government is to ensure the public's health and safety. Another role is to provide for an orderly marketplace through the regulation of commerce. Liquor sales, bomb-making tips, child pornography, all have found a home on the Internet. e-Doctors prescribe medicine with no face-to-face examination. Unwanted e-mail sometimes overwhelms users and their Internet service providers (ISP). The Internet is, in and of itself, morally neutral, as are telephones and televisions. Yet leaders must struggle with how best to encourage the Internet's growth while defending citizens against its sinister aspects.

The Committee has identified four aspects to regulation of the Internet.

- Consumer Protection
- Crime
- Commerce
- Telecommunications

Consumer Protection

The lawful and ethical practice of professions, the strength of our banking and insurance industries, the ability of the public to place trust in advertising are all important to the well-being of the state. Consumers have come to believe that the state protects them from abuses.

The Committee offers the following principles to guide actions in regard to consumer protection.

Regulation Consumer Protection Principles

- 1. Arizona consumers have the right to be protected by their government from fraudulent and unsafe business practices. The protections that currently exist for other commercial*

transactions should be extended to Internet consumers. In response to new threats to the consumer's well being, additional protections should be developed as necessary.

2. *Arizona should take an active role in the development of Interstate compacts and agreements aimed at ensuring the citizen's safety.*
3. *Laws applying to truth in advertising have even greater importance on the World Wide Web due to its non-physical and borderless nature. To compensate, citizens should incur only limited personal financial responsibility in cases where services don't meet existing state regulatory requirements.*
4. *Laws and regulations applying to professional practice should be extended to the Internet. Citizens have a right to know who is providing their legal, financial and medical advice, to be confident as to who is filling their prescriptions, and to be assured that these individuals hold the appropriate credentials, certification or license. The state will need to work with the various professional associations to ensure appropriate regulation and compliance.*
5. *Children should enjoy a higher level of protection than adults. Laws about marketing to children should be reviewed and extended in regard to the Internet.*

Crime

No part of society is free of crime and the Internet is no exception. "Too good to be true" frauds and schemes can be found online. Sales of restricted goods have always been difficult to control. For those who wanted it, information useful for criminal purposes could be obtained in paper form. However, the Internet has provided an entirely new, and in many

ways superior, method for engaging in certain criminal activities. In addition, the Internet provides opportunity for entirely new, Internet specific crimes such as "hacking."

Regulation Crime Principles

1. *If it is a crime to engage in certain activities in the physical world, it should likewise be a crime in the electronic universe. Existing laws, modified when necessary to apply to a digital environment, can and should be the primary basis for preventing abuse and penalizing criminals.*
2. *Subpoena powers should apply to anyone electronically doing business in Arizona. The state should seek reciprocity agreements with other states.*
3. *Citizens should contact local police agencies when crimes occur. Arizona should support a centralized team of cyber-crime experts to assist localities & coordinate enforcement efforts. Tools and training should be provided so that this team has the greatest expertise and technical capability possible.*
4. *The state must further evaluate its role in regard to the sale and purchase of potential criminal information (such as methamphetamine recipes) by individuals and entities.*
5. *Community standards for obscenity should apply and continue to be enforced in regard to the Internet. Enforcement efforts should be increased. Local venue should be established.*
6. *Cyber-stalking, assault via e-mail and other forms of e-communication, password theft, computer sabotage, and other damaging Internet specific*

activities should be made statutorily illegal and punishable.

7. *The state should make every effort to continue state jurisdiction over gambling activities. One leverage the state enjoys is its power to absolve gamblers from any obligation to repay debt incurred during online gambling activities.*
8. *Using the identity of another person for Internet related communication without their express authorization should be illegal under the law with specific penalties prescribed.*
9. *Child pornography is illegal in all jurisdictions and should be vigorously prosecuted when it occurs through the Internet. Each individual electronically stored image should be defined as equal to a single printed one. The state must also stipulate that a virtual pornographic image is the same as a photographic one.*

Commerce

One of the most vibrant aspects of Internet activity is commerce. Companies are finding the medium extremely suitable for displaying wares, providing product information and order taking. Wholesale, business-to-business transactions are leading the way. Retail sales are increasing at an accelerating pace and have already significantly impacted several retail categories. Arizona has an interest in maintaining the Internet as an orderly and secure marketplace. Some activities require statutory support. For example, many types of contracts that traditionally have required signed, notarized and authenticated paper copies could potentially be conducted over the Internet, if laws allowed and safeguards were in place.

The Committee offers the following principles to consider during discussions of e-commerce.

Commerce Regulation Principles

1. *Parties should have the right and means to conduct and contract equally on paper or electronically. While private sector solutions should lead, e-commerce must be allowed and supported statutorily.*
 2. *Arizona should cooperate in developing multi-state, national and international conventions in regard to conducting e-commerce.*
 3. *The ownership rights of state registered trade names and trademarks should be extended to include use of those names over the Internet. The ability of individuals to buy Internet domain names for the express purpose of later selling the name to the trade name or trademark holder or their competitor should be expressly curtailed by statute.*
 4. *Software and intellectual property theft, also known as piracy, is one of the e-industry's largest threats. Such theft should be vigorously prosecuted. Enforcement efforts should be increased within the private sector.*
 5. *Trade liberalization is the key to future international e-commerce.*
-

Telecommunications

Historically, the telecommunications industry, which is a key part of the e-industry cluster, has been one of the most highly regulated industries in Arizona. A large percentage of the telecommunications infrastructure is now devoted to data transport, considerably more than is to telephony, yet the weight of regulation remains aimed at their original purpose as telephone carriers. Distinctions between modalities are blurring. For example, companies originally distributing only

television signals now carry data and telephone transmissions yet they operate under original charters for television. Some companies are required to provide coverage to remote areas, others are not, even though they provide similar services. In the atmosphere of deregulation a multitude of questions remain and many new questions are surfacing. Accountability, access, competition, uniformity, the relationships between the various modes (wire, cable, wireless, etc.) have yet to be answered. Rules established in regard to monopoly and anti-trust in the atomic universe may be inappropriate or inadequate in an electronic one.

The following principles have been identified by the Committee:

Principles for Telecommunication Regulation

- 1. To the greatest degree possible the Internet should be kept free from government regulation.*
- 2. The state must take an active role in promoting high quality consumer choices, innovation, and broad availability regardless of geographic, socio-economic, or educational status*
- 3. Degradation of services in non-metropolitan areas of the state must be guarded against.*
- 4. The desired outcome of any regulation is a safe, fair, and competitive c-marketplace.*
- 5. Questions of open access are likely to continue for some time and be difficult to resolve. Legal challenges are likely to parallel legislative ones. The state should keep in mind the goal of developing a world-class Internet infrastructure in Arizona and providing justice for those involved. Solutions should balance rights with responsibility.*

- 6. The state should work to remove barriers that impede telecommunication competition.*

INFRASTRUCTURE

The infrastructure of the Internet is an aggregation of the equipment, people and ideas that comprise the workings of the Internet as a system. At the core of the infrastructure are the personal computers (and potentially digital assistants and televisions) where the enormous abundance of the Internet is displayed. Without a computer which provides Internet access, the Internet does not exist.

For the sake of discussions, the Internet's infrastructure is seen as having six key elements:

- Planning
- Funding Mechanisms
- Physical/Technical Components
- Maintenance and Operations
- Policies and Regulations
- Research and Marketing

Planning

The Committee believes it is essential that Arizona have a comprehensive plan to ensure that we develop and maintain those infrastructure components necessary to compete successfully in the e-economy. To remain economically competitive, the infrastructure must continually grow and develop to provide sufficient capacity to serve the needs of our constituents. These needs are as important as long-range plans for our highways, airports, waterways and other communication systems.

The Committee offers the following principles to guide discussion and debate in this area:

Infrastructure Planning Principles

1. *Arizona can enhance its position as a top competitor in the e-marketplace by planning, developing, and maintaining a world-class Internet infrastructure. Support for this goal must exist in the highest levels of government.*
2. *To create a vibrant e-industry in Arizona we need a strategic vision and plan to develop the necessary infrastructure support structures.*
3. *As part of the planning process, Arizona (through public/private cooperation) should comprehensively inventory its present Internet related infrastructure.*
4. *Arizona should appraise its competitive position in relation to other states and nations, identifying and building upon what others are doing to encourage development.*
5. *To evaluate our evolving Internet infrastructure requires benchmarks and goals. A model or prototype (outlining what would be in place in order to satisfy the information and communications needs for the early 21st century and new economy), that includes expected timelines, service capabilities, and performance standards would serve to guide actions in the state.*
6. *Barriers that exist to a successful infrastructure rollout should be assessed and plans to eliminate them should be established.*
7. *Development of the Internet infrastructure must serve the needs of all Arizona, from our most rural to our most urban communities, from the smallest businesses to the largest.*
8. *Governmental jurisdictions should cooperate in assessing needs and pooling resources to expedite*

infrastructure modernization in rural areas of the state.

9. *Street and highway project designs should, where feasible, incorporate common conduit for fiber-optic cables within the right of way.*
10. *Arizona should target obtaining an "undeserved share" of e-infrastructure. In other words, it is desirable that Arizona have a greater share of the world's e-infrastructure than is justified by the size of our population.*

Funding Mechanisms

A vibrant state economy requires capital for investment. To the greatest extent possible, these mechanisms should operate within the private sector with government regulations supporting development of the infrastructure. Government purchasing can also have an impact on the behavior of the private sector by encouraging the development of a robust infrastructure. Public-private partnerships, cooperatives, the obtaining of grants and similar methods can be employed to enhance private investment strategies. Sufficient financing is crucial for providing a foundation for Arizona's Internet infrastructure and e-industry development.

When considering potential governmental action and legislation, the following principles can be beneficial.

Infrastructure Funding Principles

1. *e-Businesses have great flexibility in regard to their choice of where to locate. Arizona must create a political and economic climate that fosters continuing and increased e-infrastructure investments.*
2. *Alternative funding methodologies are particularly necessary to stimulate*

investment in less attractive communities and for early stage business.

3. *Arizona should competitively tap all available external public and private funding sources earmarked for e-development, especially during the critical infrastructure rollout phase.*
4. *Access to a technologically literate workforce, venture and investment capital, and research and development resources are critical to the development of electronic government and commerce.*

Physical/Technical Components

The availability and quality of critical infrastructure is one essential element for supporting the entire e-industry. An understanding of components such as backbones, long haul, bandwidth, and "last-mile" availability does not just facilitate technical discussions, it is an essential ingredient to e-industry success. Once planned, it is essential to manage, develop, and maintain sufficient capacity of reliable service to continue to support e-industry over time.

The Committee offers the following concepts to guide policy discussions:

Infrastructure Technical Principles

1. *e-Infrastructure is foundational to the state's future economic viability. Arizona must recognize and protect the e-infrastructure as a fundamental component of the state's critical infrastructure.*
2. *Arizona should collaborate with the business and industry to ensure the state's access to necessary and current technology comprising the critical infrastructure.*

3. *Arizona should examine all technologies available (such as fiber, copper, coax, wireless, satellite, and infrared systems) and promote those that will best enhance the future of the state.*
4. *Arizona's ability to maintain sufficient reliable infrastructure capacity will be a significant competitive advantage in attracting and retaining e-businesses.*

Policies and Regulations

Remaining competitive with other states and nations in the information age will be a significant challenge. Change is inevitable, and rapid response to change has become a competitive advantage. Arizona policy makers must remain knowledgeable and responsive to the needs for technology-based resources and services. Though questions of rights-of-way, ownership rights, use of unlicensed spectrum, universal service, licensing, sale of rural exchanges, open access and many others will continue to be discussed and debated by all levels of government, knowledge, relationships and services are becoming equally important to physical assets in creating competitive advantage.

The Committee offers the following principles as a guide to discussion of policy and regulation.

Infrastructure Policies & Regulation Principles

1. *A new degree of cooperation will need to exist between international, federal, state and local jurisdictions.*
2. *The question of access to the telecommunications infrastructure may be decided by the courts. However, lawmakers must continue to make decisions consistent with the course of*

action that will best enhance the state's overall strategic position.

3. *Jurisdictions should adopt unified policies that:*
 - a. *Encourage investment*
 - b. *Remove barriers*
 - c. *Promote competition*
 - d. *Stimulate public/private partnerships*
4. *The government should play a role in developing infrastructure that supports educational, economic and community development throughout the state.*

Research and Marketing

Arizona markets itself to the world as a place to recreate, invest, conduct business and retire. Government effort is directed at developing recreational sites, expanding key state infrastructure, and creating a regulatory and resource climate that is both consumer and business-friendly. Arizona can, if it chooses, successfully position, market and promote our e-assets.

Infrastructure Research & Marketing Principles

The following principles would facilitate an environment attractive to new infrastructure investments:

1. *Arizona's executive leadership must sponsor and encourage development of the state's e-community.*
2. *To establish Arizona's presence in the global network economy, Arizona must position and promote our collective inventory of e-assets.*
3. *Arizona should develop an "e-Arizona" brand identification positioning the state as a dynamic environment for Internet businesses.*
4. *Public-private cooperation is essential to our success in attracting and keeping e-enterprises.*
5. *Arizona will benefit from attracting and encouraging new e-industry companies. Capital and support are often critical factors. The establishment of an e-business development "incubator" strategy (including a modest revolving fund, links to university resources, and provisions for networking or mentoring opportunities) could propel Arizona into a leadership position.*
6. *Availability of skilled, educated employees along with partnerships with universities for research and development are powerful tools in creating and marketing e-Arizona.*
7. *As in other viable business clusters, Arizona can capitalize on its strong ties to Latin America and should further develop its international relationships, especially with nations to the south. Arizona has strengths, such as a large number of Spanish speakers, that can provide an advantage in the international world of the Internet.*
8. *The Committee views the Arizona Department of Commerce as the logical choice for exerting leadership in e-industry issues and programs. The Department must be supported by other agencies of government in promoting these principles. Such agencies would include, but not be limited to, the Government Information Technology Agency, and the university and community college systems.*

e-Government

In her 1999 state of the state address, Governor Jane Dee Hull said "Information Technology is government's greatest tool in reducing costs and increasing customer satisfaction." Arizona is rapidly enabling citizen's ability to report problems, pay bills, support or protest upcoming legislation, obtain permits, sign up for

activities, renew licenses, file taxes, make park reservations, research government documents, register for classes and apply for employment "without making an appointment, waiting in line, or driving across town" writes the Government Information Technology Agency. People, "not the government will define the timing, nature and extent of access to services and information."

The Internet offers citizens an unparalleled opportunity to interact with their government. Web based information about departments, programs and operations is readily available now. Most government units are diligently increasing their online offerings. The Governor, Secretary of State, Legislature and other departments and offices already have extensive Internet based sites that allow for two-way communication, downloading of forms, even, through video streaming, observing proceedings such as the House of Representatives floor and committee sessions. The meetings of this committee were even broadcast over the Internet.

The Committee has identified four components of the e-government issue:

- e-Government
- Infrastructure Development
- Personnel
- e-Education

e-Government

The state provides an example to individuals and the private sector of how to best use the technology of the Internet and how to maintain the highest ethical standards. In this light the Committee has identified the following principles:

e-Government Principles

1. *A statewide privacy policy for state-held personally identifiable information should be developed with reasonable expectations that such information will be secured from intrusion and misuse. This privacy policy should be placed on all government sites. The principles inherent in the policy should be strictly followed.*
2. *The state should strive to form uniform policies consistent with parallel developments on a federal and international level.*
3. *When replacing aging technology, government systems should strategically plan for e-government applications and citizen access.*
4. *Internet Domain names (e.g. www.azleg.state.az.us) are a critical resource. Arizona must actively engage in national discussions about management of and changes to the .us domain. At the present time discussions are being facilitated by the National Telecommunications and Information Administration of the U.S. Department of Commerce.*

Infrastructure Development

Much as the Internet has increased efficiencies of the marketplace, it also has opened up opportunities for government to streamline its activities, thereby reducing the overhead cost associated with government's role.

Arizona can be a leading state in developing the infrastructure that supports open government access to the public through the use of the Internet. We have made progress in the past two or three years. However, there is a great deal of additional work to be done, only a small

portion of which is described in the following principles.

Infrastructure Development Principles

1. *Arizona should continue to streamline and modernize its information technology infrastructure in ways that allow it to successfully render state services online.*
2. *Development and maintenance costs should be reduced as much as possible by building commonly shared components between the departments and agencies. Allocation of cost should be based on actual use.*
3. *State agencies, law enforcement agencies in particular, require additional technology, training and statutory authority to carry out their duties in the electronic universe.*
4. *An electronically published "Internet Guide to Arizona State Government" should be published. It should include a searchable, key-worded directory of e-addresses for Arizona state government units and key personnel. This directory should be made openly accessible online and updated frequently.*

Personnel

Personnel are a key component of effective implementation. Technical skills, such as web development, data base management, and programming, are specialized tasks that require a high level of knowledge and experience. The following principle applies:

Arizona must assess and strengthen its ability to hire, develop and retain an adequate pool of skilled information technology staff.

e-Education

The Internet provides opportunities for statewide communication and cooperation. It can be a powerful tool in building our educational systems such that citizens across Arizona can access the highest quality learning opportunities possible.

The Committee has identified three principles that can lead to improving e-Education opportunities.

e-Education Principles

1. *The Arizona State Department of Education, in coordination with the Board of Regents and key state technology offices, should establish e-education standards. The standards should primarily address how learning can be enhanced through technology.*
2. *Curriculum goals and outcomes should be the guiding determinate of technology purchases and implementation.*
3. *Teacher training, sustained teacher support, and an integrated technology curriculum are critical elements to the successful implementation of technology in classrooms.*

SECURITY

Security is critical to both the privacy of electronic information and to the reliable operation of electronic government and commerce. Hackers can gain inappropriate access to insecure sites and take information or disrupt network operations and services. Viruses and other technological aggression can destroy data and effect network reliability. Effective security policies with efficient implementation are important tools to providing a fertile environment for electronic commerce to flourish.

We live in a society where a few individuals obtain pleasure in vandalizing via the Internet. A recent computer virus reached a new level by having the ability to do damage when opened as a standard e-mail message. To others, computer hacking and sabotage are deadly serious, professional and political activities.

It is important that government leaders involve high-level information technology staff to assist in forming policy in this area.

The issue of security is seen as having four major elements:

- Information Systems Security (Hardware/Physical)
- Information Security
- Transactions Security (Applications/Processes)
- Policy Administration

Information Systems Security

System security relies on trained and empowered system administration and support staff in addition to hardware and other physical components of the Internet. Users have a certain level of authority in protecting passwords, in selecting the sites that they visit, and where they go and what they do at a given site. System administration determines exactly where users can go and what they can do on a site.

Network design and operation and software configuration and administration are powerful tools to maintaining the integrity of networks and protecting electronic information. When intrusions are detected, emergency response staffs are needed to block the intrusion, restore network services and identify the violator. Policy and practice must support creating and maintaining secure network environments for electronic government and commerce.

The Committee has identified the following principles to guide discussion regarding information systems security.

Information Security Principles

1. *The state should use established, engineered architectural models for implementation of hardware, software & firmware.*
2. *Legislation regarding security should be based in established Information Technology standards.*
3. *In regard to 1. And 2 above, only those architectural models that are substantiated and supported for completeness and adequacy by the developing organization, both from a logistical and legal point of view, meet the criteria for being "established." Other evolving architectural models, particularly those models that adopt a practice of "use at your own risk" are not acceptable.*
4. *An Information Technology task force should be designated to monitor and plan network security.*
5. *Security standards and recommendations, including staffing, hardware, software, and network configurations should be developed and disseminated, particularly for electronic government applications.*
6. *Security systems should accommodate growth in all areas and be prepared for new innovations.*
7. *Network design and implementation should contain the operational behavior/properties needed to maintain a secure system against threats/responses.*
8. *Operational continuity and security are necessary to support and foster new innovations.*

9. *Security policies should be established on a framework without regard to technology and applicable to all private/public needs, using established principals/standards to accommodate "Freedom of Information."*

System Security

Certain information is deemed to require a higher level of security than other information. This process is called classification. Your name, address and telephone number, unless you have requested it be unlisted, is classified as public information. Your social security number, credit card numbers, your tax returns and medical records are all information that is expected to be classified as confidential, to be tightly protected.

Individuals may be surprised to learn how much information is already publicly available. Information security is critically important to insure that electronic information is accurate and that privacy is protected.

Commercial generation and use of electronic information is another area of concern. For example, banks own the data it collects in regard to what checks a customer writes, what charges the customer makes, what loans the customer obtains. Having fiduciary responsibility, however, the bank must take precautions to secure that information from casual observation and electronic surveillance, even though they own the information.

Increasingly, international policy and law are influencing the collection and use of electronic information.

Agencies and institutions that store data are expected to classify the data, store the data in a secure system and maintain the

integrity of the data, to protect it from harm.

The following principles in regard to the security of information have been identified by the Committee:

Systems Security Principles

1. *The owner of the information has a fiduciary responsibility for protecting that information.*
2. *The owner of the information must be identified as the best source for assessing information. Data must be classified/declassified using existing laws and procedures.*
3. *Citizens have right to correct inaccurate information regardless of who owns the information. Their right to control access to information about them needs to be determined.*
4. *Standards should be set for security and exchange of electronic information between government agencies.*

Transaction Security

Information is commonly exchanged between people engaged in transactions. A real estate listing might be displayed, an offer tendered, a contract made between buyer and seller. The rules for completing these transactions are well known in the world of paper based contracts. However, the procedures and rules are not well defined for electronic transactions. Digital signatures, electronic authentication, and other advanced methods of securing electronic commerce are just now becoming available.

In regard to the security of electronic transactions, the Committee has identified the following principles for discussion and debate.

Transaction Security Principles

1. *Policies and rules for what personally identifiable information can be obtained, collected and sold by third parties must be developed. Arizona and other state, federal and international laws must be consistent regarding data privacy and security.*
2. *There is a fine line between what information should be open to public review, and that which should remain private. Clear definitions and lines of responsibility for making these determinations must be established and disseminated.*
3. *A set of rules needs to be developed to classify public and non-public information "owned" by the State.*
4. *A "Citizens' Information Bill of Rights" should be developed that outlines citizen rights in regard to collection, storage, accuracy and use of personally identifiable information.*
5. *A lead agency should be designated which will be responsible for directing state efforts regarding the Internet, e-commerce and electronic data transfer.*
6. *Transactions legal in physical world should be legal in the cyber world.*
7. *Individuals must be able to confirm and correct information available in electronic form.*

Policy Administration

Policies regarding electronic commerce and data exchange need to be formed and administered. Practices regarding due diligence, special handling of information, correction and appeals processes, agency responsibility and authority need to be standardized and administered. Policies need to clearly address the responsibilities and practices for correcting inaccurate

electronic information. Increasingly, state policies and laws must coexist with federal and international policy and law concerning security, privacy, and use of electronic information.

The Committee has formulated the following principles in this area:

Policy Administration Principles

1. *Security policy should form a framework for protecting information without regard to a specific technology.*
2. *Policy should be applicable to all sectors, public or private, in the course of conducting business.*
3. *Policy and administration shall be based on generally acceptable security principles and standards.*
4. *Policy makers should monitor and study movements and trends in security, access, and privacy to keep Arizona laws and practices consistent with evolving federal and international laws.*
5. *Policy must strive to both promote the right to privacy of personally identifiable information as well as provide for freedom of information.*

TAXATION

Just about everyone agrees that the current system for collecting taxes on mail order sales is insufficient to deal with the world of electronic commerce.

Local governmental entities are reporting Internet impacts on both local revenues and business establishments. High value purchases such as video equipment and computers are commonly sold online. While a significant drain on state and local revenues has yet to be documented, the increasing use of the Internet forebodes increasing erosion of these revenues,

especially in select categories. A few industry representatives argue that retail sales levels are inconsequential, too small to be a threat. If this is true, recent media reports indicating significant year over year increases and e-industry accounts of rapidly increasing remote sales levels and rush to online shopping must be in error.

Given that sales and use taxes account for one-third of total state and local revenues, and that these revenues provide police and fire protection, recreation, waste management and similar services that are essential to all of us, there is ample cause for concern. When one reads in a key e-Commerce Coalition white paper, and hears the President of the United States echo it, that "the economy is thriving in large part as a result of electronic commerce"¹ an impact seems assured.

The Committee reached virtual consensus that, while appealing and politically attractive, a tax-free e-retail shopping zone makes no sense, either as tax policy or as an economic growth strategy.

Merchants are very concerned that extending the current tax system to the Internet places the onus of tax collection on them. The burden of complying individually with almost 7,500 individual taxing jurisdictions in the United States alone is daunting. A new system is needed where the burden is lifted from the seller.

The following five aspects to taxation have been identified by the Committee.

- Tax Policy
- Administration
- Economic Impact
- Types of Taxes

¹ e-Commerce Coalition white paper submitted to the Advisory Commission on Electronic Commerce, Simplification of the state and Local Sales and Use Tax System, November 15, 1999.

• Existing and Proposed Legislation

Tax Policy

For any tax system to receive public support it will need to be fair, simple and limited. Taxes should not produce winners and losers nor be used to shape the marketplace. Under the same circumstance, John Smith should be treated the same as Mary Brown. Solutions should be technology-neutral, easy to implement and simple for businesses to use.

The Committee has developed the following principles to guide discussions of tax policy.

Taxation Policy Principles

1. *Taxes should apply equally to all transactions: Internet, mail-order and telephone, as well as face-to-face.*
 2. *It is not in the best interests of the state to favor out-of-state remote sellers over in-state remote sellers and in-state brick and mortar businesses, nor would it be fair to those businesses that have invested in the state.*
 3. *Sales should be taxed, but not the use of the Internet itself.*
 4. *In a search for simplification and uniformity, it is important to respect that local jurisdictions have frequently obtained special permissions from its citizens to assess sales and use taxes for particular purposes. Mass transit, land preservation, and sports facilities are but three examples. It is essential that these local choices, based on important local needs, continue to be acceptable adjustments to tax rates.*
 5. *To establish reasonable tax policy, Arizona must answer two key questions:*
 - a. *Where does the sale take place?*
 - b. *What constitutes doing business in Arizona?*
-

Administration

Few people like taxes. Most people would, given the choice, support an end to all taxes. Yet most people understand the need to fund government operations (schools, libraries, road maintenance, police and fire protection, etc.) and will pay their taxes if compliance is relatively easy. Tax avoidance grows when the tax rate is too high. Difficulties in collection are exacerbated when the administrative burden is excessive.

Current law provides for the payment of "use taxes" directly by the purchaser when taxes are not collected by the seller. Only sellers with a physical presence in Arizona are required to collect transaction privilege (sales) taxes so use taxes generally apply to remote, out-of-state purchases. These rules were originally developed for catalogue and telephone merchants. Unfortunately, this system is not well publicized and compliance is difficult even for those who are willing to pay.

The Committee has identified the following principles to be considered in discussions of tax administration:

Tax Administration Principles

1. *It is important to recognize that the current use tax system is ineffective and unenforceable in regard to personal purchases. It needs to be revamped.*
2. *Information about how to comply with use taxes must be made available to the consumer and compliance itself made simple. Online forms, contact telephone numbers, and an electronic payment system should be available for paying use taxes. Whether or not this increases compliance needs to be documented.*
3. *Once states have simplified compliance, sellers can be asked to clearly post, at the time of sale, a notice that payment*

of use taxes is required by law and is the buyer's responsibility.

4. *In the interval prior to a suitable sales and use tax collection system becoming law, Arizona must undertake the responsibility of educating consumers of their sales and use tax obligations. This can best be achieved through a statewide educational campaign conducted only after number one above has been implemented.*
5. *The Arizona Department of Revenue must have adequate resources to perform its e-commerce related functions.*
6. *Taxing jurisdictions must cooperate in establishing common definitions and classifications across the fifty states. Procedures must be made consistent among jurisdictions.*
7. *In those cases where merchants are responsible for tax collection, a tax collecting and accounting fee (usually a percent of tax) needs to realistically match the actual value of the merchant's efforts. Merchants should not be doubly taxed by the added cost of compliance.*

Economic Impact

Tax policy has economic impact. When goods are taxed at too high a rate, sales decline. An uneven playing field promotes the favored item or type of business at the expense of another. Such inequities distort normal competitive factors.

The Committee has identified the following principles for discussions of economic impact:

Taxation Economic Impact Principles

1. *It is quite likely that a significant share of retail sales will be conducted over the Internet within a few years time.*

2. *Arizona must recognize the various threats involved in tax policy decisions including:*
 - a. *an impact on the Internet's development*
 - b. *the possibility that businesses will move or chose not to locate in Arizona if tax structures are not in their favor*
 - c. *the potential loss of local bricks and mortar establishments directly attributable to inequitable tax policies.*
3. *It is possible that a bidding war will evolve from competition among the states (and nations) to attract e-businesses. Participation in such competition must be cautiously assessed in terms of potential impact of the state and its citizens.*
4. *Arizona must keep in mind that e-businesses are easily transportable. Most e-business can be moved thousands of miles in a matter of hours.*
5. *Consumers shop the Internet for many reasons other than purported tax advantages. Convenience, price, amount of product information available, and the number of item choices may be even greater influences than tax rates on consumer behavior.*
6. *The whole of Arizona tax policy should be formed such that it is attractive to businesses, existing and new, bricks and mortar and electronic. Such a policy will help retain, expand and attract businesses of all types.*

Type of Tax

The three traditional tax bases are property taxes, income taxes and sales taxes. These three sources of revenue generate most of the funds needed to fund government services.

The Committee has identified the following principles for discussions of the types of taxation:

Type of Tax Principles

1. *Tax rates should be uniform across all methods of product sales.*
 2. *To the degree possible, the seller should be freed of the burden of tax computation, collection, remission and accounting.*
 3. *e-Technology has great potential for computing and assesses the tax as integral part of the payment process itself.*
 4. *A national sales tax, in place of a state sales tax, would likely increase Arizona's current status as a net donor to other states. Only a fraction of what goes to Washington would be returned. Factors normally associated with collection and distribution of tax funds by the federal government, including using the threat of fund withholding to force compliance in other areas, would likely result.*
 5. *Consumers can more readily observe how much they are paying in sales taxes, more so than other taxes. Imbedded taxes, such as excise and value added taxes, are more easily hidden from the consumer's awareness.*
-

Existing/Proposed Legislation

There are only a few Arizona statutes that presently deal with Internet specific matters. Other states have moved more rapidly. Many bills were introduced during recent non-Arizona legislative sessions. However, this does not mean that Arizona should rush forth. Instead, it will be important to have a measured response.

The Committee has identified several principles to guide review of existing statutes and discussions of potential legislation.

Tax Legislation Principles

1. *Until viable alternative revenue sources are identified, existing tax structures should not be dismantled.*
2. *The Internet Tax Freedom Act deals primarily with the imposition of taxes on access to and use of the Internet. Existing sales and use taxes are not impacted nor banned on Internet sale by the Internet Tax Freedom Act.*
3. *There are various court findings that impact sales taxes on the Internet. To some degree these cases conflict with each other. However, it is generally true that in order to ask a business to collect taxes on sales an "Internet plus"² nexus must exist between the business and the state. The federal government is tending to preempt the states in regard to Internet law. These preemptions are generally expanding federal authority and contracting state authority in relation to traditionally state controlled areas. Constitutional questions must be raised in regard to the rightful powers of the state.*
4. *Sales tax principles were developed for another economic time and climate. It is possible that significant changes in tax policy will be needed to accommodate the information economy of the early 21st century.*
5. *Tax rates should not be higher or lower on the Internet than at a bricks and*

² "Internet plus" implies that something more than just a passive image of information must be present for a business to be active in the state. Some form of reaching out, interactivity, or presence must be added.

mortar merchant. Tax rates should be nondiscriminatory and uniform across all methods of product sales.

6. *Attempts should be made to shift collecting responsibilities from the seller for all methods of product sales.*
7. *The Internet changes rapidly and it may be very difficult for legislation to keep pace.*

PRIVACY

The unique qualities of the Internet provide citizens with interactive, efficient ways to conduct their personal affairs. However, the astounding rate in technological advances and society's interest in the efficiency technology offers does not come without challenge. Though much personal information is already publicly available, technology has both simplified access to that data, and provides possible access to even more detailed information. For example, individuals are often unaware of the electronic footprints they leave behind as they cruise down the information highway. Every purchase, every Web page access, every electronic message and bulletin board posting leaves a trail that can potentially be monitored and tracked. In fact, the volume, ease and economy with which personal information can be collected, compiled and transmitted can significantly diminish personal privacy.

The Committee has identified four components to the overall privacy issue:

- Technology
- Rights and protections
- Consumer Issues
- Sensitive and Vulnerable Records & Information

Technology

Much of the effort aimed at insuring personal and corporate privacy comes in the form of the technology itself. Some applications software affords consumers with the means to control information placed on their machines by browsers. Other software, such as sophisticated encryption, can afford transmitted information a measure of protection in that only the intended recipient can read it. Digital signatures provide another means to assure authenticity of messages, documents, contracts and legally enforceable instruments.

The Committee has identified several principles that may be useful in developing legislation aimed at supporting technological responses for ensuring privacy.

Privacy Technology Principles

- 1. Due to the rapidly changing and improving hardware, software and standards of the Internet, statutes and regulations should avoid technology specific requirements. Specific requirements are likely to be soon outdated and inadequate or unnecessary to meet the most current threats.*
- 2. Open standards and protocols for data integrity and confidentiality preservation are preferable.*
- 3. Use automated techniques at the server level for frontline protection. Rely on independent human methods and techniques only as a backup when special case audits and remedies are required.*
- 4. Privacy can best be assured by applying privileges and permissions in a structured framework. Privileges and permission should be based on data ownership, source, and location.*

- 5. System administration and security are key to maintaining privacy. Policies should clarify and enforce the responsibility of those in positions of power to access and protect private information.*
 - 6. A computer emergency response team should be formed to support government operations. This team should be responsible for defining techniques and methods that enforce data integrity and protection against known threats and attacks.*
-

Rights and Protections

Citizens have a continuing interest in controlling when and how, if at all, personally identifiable information is disclosed, used or distributed beyond its intended purpose. Legislation, regulation, and litigation often derive out of the corresponding opinion that there is, or should be, an individual right to control personal information.

Several studies have determined that consumers will distrust online companies and remain wary of electronic commerce until effective consumer privacy protections are implemented. These researchers believe that without implementation of privacy measures the online marketplace will fail to reach its full potential.

In addition, certain businesses will be extremely cautious about fully implementing e-commerce applications until intellectual property rights and trade secrets are more comprehensively protected in cyberspace.

The Committee has identified the following principles regarding rights and protections:

Privacy Rights & Protections Principles

1. *Personally identifiable and disclosed information should be distributed only with informed consent. Clear and convincing rationale should be presented in order to bypass an individual's right to control distribution beyond the information's original, consented purpose.*
 2. *There is a delicate balance between the rights of an employer to control the workplace and an employee's right to privacy. Rights of employer and employee should be clearly enumerated in regards to an employee's use of technology, owned by the employer, in the workplace.*
 3. *Laws relating to privacy in the non-internet world should be consistently applied in the virtual world.*
 4. *Consumers should be provided obvious, clear and understandable information as to how their personally identifiable information is to be used.*
 5. *Consumers should have readily available and ongoing opportunities to opt out of consumer tracking.*
 6. *Consumers should be notified when data about them is being collected, consolidated, shared or sold.*
 7. *Consumers ought to have the ability to undo consent easily and quickly.*
 8. *The collection, sharing and distribution of consumer information should not be restricted within a single company or restrict the ability of a consumer to designate a personal representative to receive specific information.*
-

Citizen Issues

Businesses and profilers call us users, customers, clients. Though these terms can

make it seem like we are anonymous clumps of data, we are really living, breathing human beings. As private people, we don't necessarily want other people knowing where we shop, how much money we make, what type of car we drive, where we work, what computer we own.

When we "browse" web sites and retrieve information from the Internet we often leave a record of many of our online activities including newsgroups we access and web sites we visit. This information is collected both by the local service provider and by the system operators of remote sites visited. No one is truly anonymous in cyberspace, just as no one is anonymous when they go to the local mall or to a bar down the street. Clear, shared understanding between users and service providers of what can be done with such information is critical to successful development of electronic government and commerce.

There is great profit in selling lists of potential buyers. Businesses want to know as much as they can about their customers and e-businesses are no exception. The Internet is one of the most active and sophisticated areas for what is called "data mining." Very large collections of data—millions or even hundreds of millions of individual records—can now be compiled into centralized data warehouses where techniques of "knowledge discovery" are used to organize and interpret the data. The scope and depth of knowledge discovery from both private and public sources is growing dramatically.

The Committee has identified several principles that apply to these personally relevant privacy issues.

Citizen Privacy Principles

1. *Each individual must be involved and responsible for protection of their own privacy. Law cannot protect the person who knowingly and carelessly divulges personally identifiable information.*
2. *Internet users should be extremely cautious when giving out their name, address, telephone number or email address. Online users should educate themselves about what information is being transmitted to remote computers by their browser software.*
3. *Parents should teach their children that giving out personal information is like giving it to strangers.*
4. *The e-industry should engage in educational efforts to teach users about privacy issues and their rights as a first step toward self-protective actions.*
5. *Sites should be required to disclose privacy policies and state the possible uses of any personally identifiable information collected. Individuals should be given the opportunity to verify the accuracy of their personal data, and have some level of control over its use.*
6. *Government and e-Industry should cooperate in providing a central, perhaps international, consumer information referral center for complaints and notifying the public of known threats to personal privacy.*
7. *Governmental response should be measured, allowing for private sector responses for privacy protection. Online divisions of traditional consumer protection organizations (such as the Better Business Bureau) and their newer counterparts are increasingly helping shape business practices on the Internet. A coalition of privacy sector leaders is putting forth new standards that will allow computer users broad new options to limit the information given out during online browsing.*
8. *Arizona should join with the other forty-nine states and industry representatives in developing voluntary privacy standards for the public and private sectors. If these voluntary privacy standards prove inadequate, efforts should be made to place standards into law.*
9. *Voluntary standards should define limitations on and responsibilities of those individuals and organizations distributing unsolicited e-mail (aka SPAM). However, the use of fraudulent e-mail headers that are used to disguise the source of the e-mail, should be prohibited.*
10. *Policy makers should monitor evolving federal and international policy and law regarding Internet privacy and use of electronic information.*

Sensitive and Vulnerable Records and Information Principles

Various electronically stored records, such as financial and health, are of a particularly sensitive nature. Information obtained from and about people under the age of twenty-one are also of this type.

The Committee has formed the following principles in this regard:

Privacy Records & Information Principles

1. *The persons to whom information pertains, their guardian or their assignees, should have input into the ownership, collecting, amending, protecting, safeguarding, storing, transmitting, releasing, and destroying of electronically stored information.*
2. *State policy should be established to guide the rules for ownership,*

collecting, amending, protecting, safeguarding, storing, transmitting, releasing, and destroying electronically stored information. Protection afforded must be based upon specifically recognized and cited privileges and permissions. Where unspecified, protection should not be afforded.

3. *Existing statutory frameworks that protect a person's reasonable expectation of privacy in regard to data and records should be extended to apply to data collected by or through computer networks.*
4. *The public has a right to expect that electronic records will have a similar longevity to paper records. To develop equality between paper and electronic transactions, consistent rules for data storage in electronic form, data aging, data downgrading, and data destruction is necessary.*
5. *Arizona should encourage industry and government agencies to adopt reasonable personnel procedures to educate employees about information that the employee has ownership rights to view, read or use for other purposes*
6. *Individuals must have access to personal information about them that an organization holds and be able to correct, amend or delete that information where it is inaccurate.*

CONCLUSION

To some the Internet is a fire-breathing dragon ready to devour its prey. To others the Internet is freedom, providing access to the world in heretofore-unavailable ways. For most of us, the Internet is a tool allowing us to communicate, shop, gather information and recreate more easily and more quickly.

There is little doubt that the Internet will have a similar impact as did the introduction of the radio and later television. It will transform our lives in still unexpected ways.

The Internet is a fundamental component in the state's critical infrastructure, not unlike roads and airports. It is essential that Arizona act quickly to take advantage of the current rush of infrastructure rollout. States that have the infrastructure in place will be at a definite advantage in both the near and far term.

Arizona must first look to its core infrastructure. Initial investments will naturally concentrate in high-density downtown business districts and edge city office parks. And then Arizona must look beyond. The continued vitality of small towns, less affluent areas of the central cities, suburbs and rural areas, depends on the ability of individuals, businesses and public institutions to obtain affordable access to new, high-speed broadband networks, just as they depend on adequate access to airports, railroads and highways. Those that do not have access risk being left behind in the dust of progress.

There is a window of opportunity to forge Arizona into an e-industry leader. Competition will be stiff and worldwide. If we act quickly and strategically to take advantage of our strengths, Arizona will be an e-leader in the 21st century.

Appendix I:

Laws 1999, Chapter 264

Senate Engrossed House Bill	
State of Arizona House of Representatives Forty-fourth Legislature First Regular Session 1999	
CHAPTER 264	
HOUSE BILL 2639	

AN ACT

ESTABLISHING A STUDY COMMITTEE ON INTERNET PRIVACY, JURISDICTION, REGULATION AND TAXATION.

Be it enacted by the Legislature of the State of Arizona:

Section 1. Study committee on internet privacy, jurisdiction, regulation and taxation

A. The study committee on internet privacy, jurisdiction, regulation and taxation is established consisting of:

1. Five members of the house of representatives who are appointed by the speaker of the house of representatives, no more than three of whom may be from the same political party.

2. Five members of the senate who are appointed by the president of the senate, no more than three of whom may be from the same political party.

3. One member who represents the government information technology agency and who is appointed by the governor.

4. One member who has legal experience in relation to the internet and who is appointed by the governor.

5. One member who has expertise in internet technology and systems, who represents one of the state universities and who is appointed by the governor.

6. A member of the public who has expertise as a mail order sales representative and who is appointed by the governor.

7. A member of the public who has expertise regarding the internet and who is appointed by the governor.

8. A member of the public who represents the electronic commerce industry and who is appointed by the governor.

B. The committee shall elect from among its members a chairman.

C. The committee shall conduct hearings and complete a study on internet privacy, jurisdiction, regulation, taxation, electronic mail and twenty-first century communications systems.

D. The committee shall submit a report containing the committee's findings and legislative recommendations by December 1, 1999 to the governor, the speaker of the house of representatives and the president of the senate. The committee shall provide a copy of the report to the secretary of state and the director of the department of library, archives and public records.

E. Members of the committee are not eligible to receive compensation but are eligible for reimbursement of expenses pursuant to title 38, chapter 4, article 2.

F. The legislature shall provide staff, administrative and technical support and meeting space to the committee. The committee may use services and staff of the executive branch that the governor makes available.

Sec. 2. Delayed repeal

This act is repealed from and after June 30, 2000.

APPROVED BY THE GOVERNOR MAY 17, 1999.

FILED IN THE OFFICE OF THE SECRETARY OF STATE MAY 18, 1999.

Appendix II:

Committee Agendas & Minutes

ARIZONA STATE LEGISLATURE**INTERIM MEETING NOTICE**
OPEN TO THE PUBLIC**STUDY COMMITTEE ON INTERNET PRIVACY, JURISDICTION,
REGULATION AND TAXATION**

Date: Tuesday, September 7, 1999
Time: 2:00p.m. – 4:00p.m.
Place: Senate Hearing Room 3

AGENDA

1. Opening Remarks
2. Elect Chairman
3. Task of the Committee
4. Staff Overview of Issues
 - A. Internet Infrastructure – Melodie Jones
 - B. Internet Security – Tami Stowe
 - C. Internet Regulation – Ken Behringer
 - D. Internet Privacy – Tami Stowe
 - E. Internet Taxation – Jeff Kros
 - F. Internet Jurisdiction – Ken Behringer
5. Discussion
6. Public Comment
7. Administrative Issues – Future Committee Meeting Schedule/Agenda
8. Adjournment

Representative Jeff Hatch-Miller**Members:****Representatives:**

Jeff Hatch-Miller, Co-Chair
Barbara Leff
Debora Norris
Ramon Valadez
Barry Wong

Senators:

Scott Bundgaard, Co-chair
Ken Bennett
George Cunningham
Harry E. Mitchell
Marc Spitzer

Members: Appointed by the Governor

Michelle Alhmer, AZ Retailers Association
The Honorable Chris Bavasi, Mayor of City of Flagstaff
Peter Charleton, MCI WorldCom
John Kelly, Director of GITA (Government Information Technology Agency)
Dr. William E. Lewis, ASU Information Technology
Michael McNulty, Attorney-Tucson

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09/01/99- 09/02/99

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ARIZONA STATE LEGISLATURE

INTERIM MEETING NOTICE OPEN TO THE PUBLIC

STUDY COMMITTEE ON INTERNET PRIVACY, JURISDICTION, REGULATION AND TAXATION

Date: Wednesday, September 22, 1999

Time: 2:30p.m. – 4:30p.m.

Place: Senate Appropriations Room 109

AGENDA

1. Call to Order
2. Note Attendance
3. Public Testimony on Internet Security Issues
4. Committee Discussion
5. Administrative Matters
6. Adjournment

Representative Jeff Hatch-Miller

Members:

Representatives:


Jeff Hatch-Miller, Co-Chair
Barbara Leff
Debora Norris
Ramon Valadez
Barry Wong

Senators:

Scott Bundgaard, Co-chair
Ken Bennett
George Cunningham
Harry E. Mitchell
Marc Spitzer

Members: Appointed by the Governor

Michelle Ahlmer, AZ Retailers Association
The Honorable Chris Bavasi, Mayor of City of Flagstaff
Peter Charlton, MCI WorldCom
John Kelly, Director of GITA (Government Information Technology Agency)
Dr. William E. Lewis, ASU Information Technology
Michael McNulty, Attorney-Tucson

 ^{rb}
09/20/99

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ARIZONA STATE LEGISLATURE

INTERIM MEETING NOTICE OPEN TO THE PUBLIC

STUDY COMMITTEE ON INTERNET PRIVACY, JURISDICTION, REGULATION AND TAXATION

Date: Wednesday, October 6, 1999
Time: 2:30p.m. – 4:30p.m.
Place: Senate Appropriations Room 109

AGENDA

1. Call to Order
2. Note Attendance
3. Public Testimony on Internet Jurisdiction and Regulation Issues
4. Committee Discussion
5. Administrative Matters
6. Adjournment

Representative Jeff Hatch-Miller

Members:

Representatives:

Jeff Hatch-Miller, Co-chair
Barbara Leff
Debora Norris
Ramon Valadez
Barry Wong

Senators:

Scott Bundgaard, Co-chair
Ken Bennett
George Cunningham
Harry E. Mitchell
Marc Spitzer

Members: Appointed by the Governor

Michelle Ahlmer, AZ Retailers Association
The Honorable Chris Bavasi, Mayor of City of Flagstaff
Peter Charlton, MCI WorldCom
John Kelly, Director of GITA (Government Information Technology Agency)
Dr. William E. Lewis, ASU Information Technology
Michael McNulty, Attorney-Tucson

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09/30/99

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ARIZONA STATE LEGISLATURE

INTERIM MEETING NOTICE OPEN TO THE PUBLIC

STUDY COMMITTEE ON INTERNET PRIVACY, JURISDICTION, REGULATION AND TAXATION

Date: Wednesday, October 20, 1999
Time: 2:30p.m. – 4:30p.m.
Place: Senate Appropriations Room 109

AGENDA

1. Call to Order
2. Note Attendance
3. Public Testimony on Internet Regulation and Infrastructure Issues
4. Committee Discussion
5. Administrative Matters
6. Adjournment

Representative Jeff Hatch-Miller

Members:

Representatives:

Jeff Hatch-Miller, Co-chair
Barbara Leff
Debora Norris
Ramon Valadez
Barry Wong

Senators:

Scott Bundgaard, Co-chair
Ken Bennett
George Cunningham
Harry E. Mitchell
Marc Spitzer

Members: Appointed by the Governor

Michelle Ahlmer, AZ Retailers Association
The Honorable Chris Bavasi, Mayor of City of Flagstaff
Peter Charlton, MCI WorldCom
John Kelly, Director of GITA (Government Information Technology Agency)
Dr. William E. Lewis, ASU Information Technology
Michael McNulty, Attorney-Tucson

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10/14/99

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ARIZONA STATE LEGISLATURE

INTERIM MEETING NOTICE OPEN TO THE PUBLIC

STUDY COMMITTEE ON INTERNET PRIVACY, JURISDICTION, REGULATION AND TAXATION

Date: Wednesday, November 3, 1999
Time: 2:30p.m. – 4:30p.m.
Place: Senate Appropriations Room 109

AGENDA

1. Call to Order
2. Note Attendance
3. Public Testimony on Internet Infrastructure and Taxation Issues
4. Committee Discussion
5. Administrative Matters
6. Adjournment

Representative Jeff Hatch-Miller

Members:

Representatives:

Jeff Hatch-Miller, Co-chair
Barbara Leff
Debora Norris
Ramon Valadez
Barry Wong

Senators:

Scott Bundgaard, Co-chair
Ken Bennett
George Cunningham
Harry E. Mitchell
Marc Spitzer

Members: Appointed by the Governor

Michelle Ahlmer, AZ Retailers Association
The Honorable Chris Bavasi, Mayor of City of Flagstaff
Peter Charlton, MCI WorldCom
John Kelly, Director of GITA (Government Information Technology Agency)
Dr. William E. Lewis, ASU Information Technology
Michael McNulty, Attorney-Tucson

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10/29/99

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ARIZONA STATE LEGISLATURE

INTERIM MEETING NOTICE OPEN TO THE PUBLIC

STUDY COMMITTEE ON INTERNET PRIVACY, JURISDICTION, REGULATION AND TAXATION

Date: Wednesday, November 17, 1999

Time: 2:30p.m. – 4:30p.m.

Place: Senate Hearing Rooms 2 and 3

AGENDA

1. Call to Order
2. Note Attendance
3. Public Testimony on Internet Privacy Issue
4. Committee Discussion
5. Administrative Matters
6. Adjournment

Representative Jeff Hatch-Miller

Members:

Representatives:

Jeff Hatch-Miller, Co-chair
Barbara Leff
Debora Norris
Ramon Valadez
Barry Wong

Senators:

Scott Bundgaard, Co-chair
Ken Bennett
George Cunningham
Harry E. Mitchell
Marc Spitzer

Members: Appointed by the Governor

Michelle Ahlmer, AZ Retailers Association
The Honorable Chris Bavasi, Mayor of City of Flagstaff
Peter Charlton, MCI WorldCom
John Kelly, Director of GITA (Government Information Technology Agency)
Dr. William E. Lewis, ASU Information Technology
Michael McNulty, Attorney-Tucson

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11/10/99

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ARIZONA STATE LEGISLATURE

Joint Interim Meeting Notice

Open to the Public

SUBCOMMITTEE ON REGULATION OF THE STUDY COMMITTEE ON INTERNET PRIVACY, JURISDICTION, REGULATION AND TAXATION

DATE: Monday, November 8, 1999

TIME: 1:00 p.m. - 5:00 p.m.

PLACE: House Basement Room 049

SUBJECT: Regulation

Discussion/Developing Principle Statements

MEMBERS:

✓ Representative Ramon Valadez - 23424
✓ John Kelly - 340-8538 x 203

✓ Senator Ken Bennett - ~~2558~~ 5584
✓ Michael McNulty - 520 798-7908

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11/4/1999

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ARIZONA STATE LEGISLATURE

Joint Interim Meeting Notice

Open to the Public

SUBCOMMITTEE ON JURISDICTION OF THE STUDY COMMITTEE ON INTERNET PRIVACY, JURISDICTION, REGULATION AND TAXATION

DATE: Tuesday, November 9, 1999
TIME: 9:00 a.m. – 12:00 p.m.
PLACE: Senate Majority Caucus Room
SUBJECT: Jurisdiction

Discussion/Developing Principle Statements

MEMBERS:
Senator Harry E. Mitchell

Mayor Chris Bavasi
Michael McNulty

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11/5/1999

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ARIZONA STATE LEGISLATURE

Joint Interim Meeting Notice

Open to the Public

SUBCOMMITTEE ON INFRASTRUCTURE OF THE STUDY COMMITTEE ON INTERNET PRIVACY, JURISDICTION, REGULATION AND TAXATION

DATE: MONDAY, NOVEMBER 15, 1999

TIME: 9:00 a.m. - 12:00 p.m.

PLACE: HOUSE BASEMENT ROOM 038

SUBJECT: INFRASTRUCTURE

Discussion/Developing Principle Statements

MEMBERS:

Representative Ramon Valadez
Representative Barry Wong

Peter Charlton
John Kelly
William E. Lewis
Michael McNulty

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12/1/1999

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ARIZONA STATE LEGISLATURE

Joint Interim Meeting Notice

Open to the Public

SUBCOMMITTEE ON SECURITY OF THE STUDY COMMITTEE ON INTERNET PRIVACY, JURISDICTION, REGULATION AND TAXATION

DATE: TUESDAY, NOVEMBER 16, 1999

TIME: 9:00 a.m. - 12:00 p.m.

PLACE: HOUSE BASEMENT ROOM 049

SUBJECT: SECURITY

Discussion/Developing Principle Statements

MEMBERS:

Representative Barbara Leff
Representative Barry Wong

Peter Charlton
John Kelly
William E. Lewis

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12/1/1999

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ARIZONA STATE LEGISLATURE

Joint Interim Meeting Notice

Open to the Public

SUBCOMMITTEE ON TAXATION OF THE STUDY COMMITTEE ON INTERNET PRIVACY, JURISDICTION, REGULATION AND TAXATION

DATE: WEDNESDAY, NOVEMBER 17, 1999

TIME: 9:00 a.m. - 12:00 p.m.

PLACE: HOUSE BASEMENT ROOM 038

SUBJECT: TAXATION

Discussion/Developing Principle Statements

MEMBERS:

Representative Barbara Leff
Representative Ramon Valadez
Representative Barry Wong

Senator Ken Bennett
Senator George Cunningham
Senator Harry E. Mitchell
Mayor Chris Bavasi

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12/1/1999

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ARIZONA STATE LEGISLATURE

Joint Interim Meeting Notice

Open to the Public

SUBCOMMITTEE ON PRIVACY OF THE STUDY COMMITTEE ON INTERNET PRIVACY, JURISDICTION, REGULATION AND TAXATION

DATE: THURSDAY, NOVEMBER 18, 1999

TIME: 9:00 a.m. - 12:00 p.m.

PLACE: HOUSE BASEMENT ROOM 038

SUBJECT: PRIVACY

Discussion/Developing Principle Statements

MEMBERS:

Representative Debra Norris
John Kelly
Michael McNulty

Senator George Cunningham
William E. Lewis

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12/1/1999

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ARIZONA STATE LEGISLATURE
Forty-fourth Legislature – First Regular Session

JOINT LEGISLATIVE STUDY COMMITTEE ON
INTERNET PRIVACY, JURISDICTION, REGULATION AND TAXATION

Minutes of Meeting
Tuesday, September 7, 1999
Senate Hearing Room 3 – 2:00 p.m.

(Tape 1, Side A)

The meeting was called to order at 2:04 p.m. by Chairman Hatch-Miller. The attendance was noted by the secretary.

Members Present

Senator Bundgaard, Co-Chairman
Senator Cunningham
Senator Mitchell
Senator Spitzer
Michelle Ahlmer
Mayor Chris Bavasi
Peter Charlton

Representative Hatch-Miller, Chairman
Representative Leff
Representative Norris
Representative Wong
John Kelly
Dr. William E. Lewis
Michael McNulty

Members Absent

Senator Bennett

Representative Valadez

Speakers

Tami Stowe, House Analyst, Committee on Counties and Municipalities, Committee on Government Operations

Melodie Jones, House Analyst, Committee on Ways and Means

Ken Behringer, Staff, Legislative Council

Jeff Kros, Senate Analyst, Committee on Finance

Terry Trost, Assistant Director, Transaction Privilege Use Taxation Division, Department of Revenue

Opening Remarks

Tami Stowe, House Analyst, Committee on Counties and Municipalities, Committee on Government Operations, reviewed the purpose, duties, reporting requirements, and membership of the Joint Legislative Study Committee on Internet Privacy, Jurisdiction, Regulation and Taxation (IPJRT) (Attachment 1).

Elect Chairman

Senator Bundgaard moved that the Study Committee elect Representative Hatch-Miller as its Chairman. The motion carried.

Task of the Committee

Chairman Hatch-Miller introduced the Members of the Committee.

Senator Bundgaard echoed Ms. Stowe's opening remarks that the purpose of IPJRT is to raise Internet-related issues, increase the awareness of the Committee Members on those issues, and then arrive at policy recommendations with regard to the Internet. With regard to taxation, IPJRT will take into account the Internet Tax Freedom Act, which imposed a three-year moratorium (10/1/99 – 10/21/01) on certain state and local taxes pertaining to Internet access services and multiple/discriminatory taxes on electronic commerce. The Committee will use the Act as a guide in future, local Internet taxation.

Chairman Hatch-Miller noted that the meeting is being videotaped by representatives of Salt River Project and that the meeting, in its video form, may be viewed on the Internet. He explained that it is important for a Committee addressing the power and complexity of the Internet to make as much effective use of it as possible.

By way of introduction and also to place the emerging technology of the Internet in context, Chairman Hatch-Miller made a presentation on *Public Internet Policy* (Attachment 2).

Chairman Hatch-Miller encouraged the Members to communicate with him via phone, fax, and E-mail; however, he cautioned that too much contact via E-mail may subject the communiqués to open meeting laws.

Staff Overview of Issues

Ms. Stowe presented an outline of the Internet-related issues IPJRT will investigate throughout its subsequent meetings (Attachment 3).

Internet Infrastructure

Melodie Jones, House Analyst, Committee on Ways and Means, presented an overview of Internet infrastructure (Attachment 4, Pages 1-4).

Internet Security

Ms. Stowe presented an overview of Internet security (Attachment 4, Pages 5-8).

Mr. Kelly noted that, under statute, there is legal policy that surrounds the use of electronic signatures and it must be attended to. He added that the Government Information Technology Agency (GITA) is working on the technology side of the issue in order to appropriate divisional responsibilities.

Chairman Hatch-Miller explained that one application of electronic signatures might be the E-mailing of signed, legal documents over the Internet, and that such signatures must, through some process, be authenticated.

Internet Regulation

Ken Behringer, Staff, Legislative Council, presented an overview of Internet regulation (Attachment 4, Pages 9-11).

Senator Bundgaard asked how successful the State of California was in enforcing its laws against spam, unsolicited junk E-mails, and if it was costly. Mr. Behringer indicated that such regulations are not easily or actively enforced.

Representative Norris asked if Internet regulation is handled by local law enforcement, or if there exist "cyber units" who address infractions. Mr. Behringer explained that "cyber units" typically assist local law enforcement and that the units with more expertise were at the state level.

Dr. Lewis commented that spam is nothing more than junk mail. He also pointed out that, with regard to disclosing one's credit card number via the Internet, people have been giving their credit card number via telephone for years, presumably in point-to-point transactions. He advised the Committee to avoid overreaction when it comes to Internet regulation, and he suggested that, in most cases, concerns that arise with regard to the Internet are being dealt with now in other forms.

(Tape 1, Side B)

Internet Privacy

Ms. Stowe presented an overview of Internet privacy (Attachment 4, Pages 12-16).

Representative Wong cautioned the Committee to take a "very restrained" approach, from a government perspective, so that emergent industries are not inadvertently choked off. However, in the arena of cyber crime, especially the activities of sex predators, Mr. Wong advocated that the Legislature work closely and actively with the Attorney General's Office.

Internet Taxation

Jeff Kros, Senate Analyst, Committee on Finance, presented an overview of Internet taxation (Attachment 4, Pages 17-23).

Mr. McNulty asked if Microsoft is required to collect taxes and remit them to the State of Arizona when someone purchases and downloads a software program from them. Mr. Kros conceded that the issue of use tax is a gray area, though the State does have authority to collect use tax from vendors. He explained that out-of-state vendors, such as catalog companies, do not wish to risk an audit and are usually willing to collect the use tax.

Mr. Wong asked staff to investigate the following issues for future meetings:

- Hypothetically, what if the federal government chose not to extend the moratorium on local governments applying Internet taxation on E-commerce and Arizona elected to have a five-year moratorium.
- How would that affect multi-state E-commerce and how might it impact constitutional and jurisdictional issues.
- How would the Department of Commerce suggest the Legislature prepare the state, with regard to an Internet tax policy, to attract E-commerce, and perhaps also incorporate E-commerce as a cluster in the Governor's Strategic Partnership for Economic Development (GSPED) in that it might attract additional industry to the State.
- Reconcile the conflicting data regarding E-commerce, specifically its effect on local taxes.

Representative Wong speculated that there will, ultimately, not be a great loss of business for bricks and mortar stores; however, people will spend more of their discretionary money on the Internet because of the convenience factor.

Chairman Hatch-Miller noted that the discussion has brought out two important points IPJRT will be dealing with: 1) what constitutes doing business in Arizona, and 2) where does the sale take place?

Internet Jurisdiction

Mr. Behringer presented an overview of Internet jurisdiction (Attachment 4, Pages 24-27).

Discussion

Chairman Hatch-Miller commended staff on the presentations and acknowledged that there is a great deal of information for the Committee to "digest." He stated that the Committee will simply work its way through the subject areas step by step.

Representative Leff noted that reporting/remitting use tax is the responsibility of the person receiving the property. She asked how, if at all, this is impacted by the current moratorium on Internet sales. Ms. Jones indicated that there is no impact, and that it is the responsibility of the purchaser to self-report use tax; however, that does not always happen.

Terry Trost, Assistant Director, Transaction Privilege Use Taxation Division, Department of Revenue, explained that there is nothing in the moratorium that affected Arizona taxation. Mr. Trost clarified that if an Arizona resident makes a purchase for use, consumption or storage in the State, then they are subject to the use tax. Additionally, the physical presence of the resident in Arizona produces nexus for the application of the use tax, even if the vendor is located out of state and contacted via the Internet. Furthermore, this transaction privilege use tax is in alignment with every other state.

Mr. Wong asked, hypothetically, if a company has administrative or distribution offices in Arizona and they distribute or sell out of another state, would they collect a state sales tax through E-commerce. Mr. Trost explained that transaction privilege tax and use tax ought to be thought of as two separate taxes with distinct criteria. However, Mr. Trost added, there are circumstances, under the Quill decision, in which sufficient nexus occurs and companies will collect and remit to the state, in this case Arizona, a use tax.

Senator Cunningham stressed the importance of this issue, specifically in terms of the responsibilities incumbent on the seller, the purchaser, the vendor, and the State with regard to use tax. He stated that he feels it is important for the Committee to understand what the current law dictates on this issue. Senator Cunningham asked Mr. Trost what he believed the level of compliance is among out-of-state vendors, with regard to use tax. Mr. Trost indicated that the compliance level among major corporations is in the 90 to 95 percent range. However, when the smaller businesses are considered, the compliance level drops off. This may be due to ignorance of their fiscal responsibilities to the State or they may not realize that they have a sufficient presence in Arizona to generate a nexus requirement.

Representative Leff suggested there is a need to clarify these consumer responsibilities to the public, specifically the obligation to pay use tax when engaging in E-commerce. She asserted that this task ought to be taken up by the print media.

Mr. Trost noted that the issue of use tax has applied to many forms of remote selling in the past (such as catalog purchases, telephone sales, TV marketing sales, etc.), and that E-commerce does not create a new aspect to the use tax.

Administrative Issues – Future Committee Meeting Schedule/Agenda

Chairman Hatch-Miller reminded the Committee that guest speakers will appear at future meetings to speak to the aforementioned issues more fully. He asked the Members to submit their availability to him after the meeting so that he can formulate a meeting time that will accommodate everyone's schedule. Additionally, he encouraged the Members to offer any comments and suggestions regarding his intended approach of the six areas he had delineated.

Senator Cunningham commended Chairman Hatch-Miller for his leadership and efforts. He suggested that the Herculean task before the Committee might be more effectively handled through liberal use of subcommittees that could focus on specific Internet-related issues and report back to the full Committee. Chairman Hatch-Miller thanked Senator Cunningham for his suggestion and stated that he may make use of subcommittees as long as they do not detract from the spirit of open dialogue. He explained that subcommittees may give an air of exclusivity and he would like to avoid that perception.

Representative Wong echoed Senator Cunningham's commendation, and encouraged Chairman Hatch-Miller to include a broad base of stake holders (such as the League of Cities and Towns, the County Supervisors Association, the Arizona Software Internet Association, etc.) and allow them to present to the Committee at future meetings.

Without objection, the meeting adjourned at 4:07 p.m.



Seth Goodman, Committee Secretary

(Original minutes, attachments, and tape on file in the Chief Clerk's Office. Copy of minutes on file in the Senate Secretary's Office.)

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9/9/99

Summary of Meeting

**Staff of the Study Committee on Internet Privacy, Jurisdiction, Regulation and Taxation
August 19, 1999**

Room 38, Arizona House of Representatives

In attendance:

Representative Jeff Hatch-Miller, Committee, Co-chair; Ken Behringer, Kristi Clark, Janet Fisher, Chris Gordon, Cathy Griffin, Brian Schmitz, Terry Trost

Mr. Hatch-Miller provided an overview of the purposes of the Committee and staff's role in assisting the committee.

Mr. Behringer provided portions of statutes that contained the word "Internet" and other statutes that might need to be amended to include the internet within their scope. Mr. Hatch-Miller stated that a more in depth review of these statutes would have to be made at a later time.

Mr. Trost reported that the Department of Revenue was preparing a draft of a paper addressing issues under the taxation category. The paper is currently being reviewed throughout the department and should be available by the next meeting.

Ms. Fisher and Mr. Hatch-Miller discussed the role of the Department of Library, Archives and Public Records with the committee. It was agreed that the DLAPR would not take the lead on preparing issues, but would support those who were taking the lead.

Ms. Clark provided copies of the State Strategic Plan for Information Technology.

**ARIZONA HOUSE OF REPRESENTATIVE
Forty-fourth Legislature – First Regular Session**

**STUDY COMMITTEE ON INTERNET PRIVACY,
JURISDICTION, REGULATION AND TAXATION**

Minutes of Meeting
Wednesday, September 22, 1999
Senate Appropriations Room 109 – 2:30 p.m.

(Tape 1, Side A)

The meeting was called to order at 2:35 p.m. by Co-Chairman Hatch-Miller. The attendance was noted by the secretary.

Members Present

Senator Bundgaard, Co-Chairman
Senator Bennett
Senator Cunningham
Senator Mitchell
The Honorable Chris Bavasi
Peter Charlton
Dr. William E. Lewis

Representative Hatch-Miller, Co-Chairman
Representative Leff
Representative Norris
Representative Valadez
Representative Wong
John Kelly
Michael McNulty

Members Absent

Senator Spitzer

Michelle Ahlmer

Speakers

Dave Rowand, Deputy Chief Information Officer, Information Technology Division, Arizona Department of Revenue (DOR)
Tim Yopp, President/CEO, Palo Verde Software; Founder, Information Technology Association of Southern Arizona (ITASS)
Gail Thackery, Attorney, Arizona Attorney General's Office
Steven Ellis, Director, Security and Privacy Policy, Intel
Russell D. Smoldon, Manager, Government Relations, Salt River Project (SRP)
Joe McKee, Principal Electrical Engineer, Network Management, Salt River Project (SRP)
Lee Lane, Statewide Security Manager, Arizona Department of Administration (ADOA)
Ken Behringer, Staff, Legislative Council

Public Testimony on Internet Security Issues

Dave Rowand, Deputy Chief Information Officer, Information Technology Division, Arizona Department of Revenue (DOR), explained that DOR is facing the challenge of providing access to end users via the Internet while preserving the integrity of its data. Throughout this process, DOR has sought to provide security that exceeds federal and Internal Revenue Service (IRS)

guidelines, and complies with the standards established by the Government Information Technology Agency (GITA).

Among the components of DOR's security strategy are: firewall protection between DOR, other agencies and its vendors; SMTP (Simple Mail Transfer Protocol) gateway, virus scanning; URL (Universal Resource Locator); system log analysis tools (Internet-use log). In response to questions posed by the Committee, Mr. Rowand added:

- It is an accurate characterization that DOR has sought isolation from the rest of the network as one component of its security strategy.
- This insulation of taxpayer data is critical in order to comply with federal/IRS agreements regarding information sharing. This requires that State data be maintained to the same standards and levels of security as federal data.
- Initially, efforts will be made to secure the Call Center. Eventually, the focus will shift to evolving forms of electronic commerce (e-commerce) and taxpayer access into the system. To this end, DOR is making liberal use of products, security models, and established guidelines.
- Department of Administration's is providing web hosting services to DOR to protect it against forms of e-mail attack. All outside Internet contacts must go through this LAN/WAN (Local Area Network/Wide Area Network).
- With regard to the filing of tax returns, currently, tax practitioners (e.g., H&R Block) prepare a tax return and send the data to the IRS. The IRS acts as a holding tank for the State forms. In the future, tax practitioners will be directed to send tax data to DOR, and DOR would then direct-dial to the IRS using encryption, rather than communicating via the Internet using firewall security.
- In the previous year, 140,000 taxpayers took advantage of electronic filing. The year before that was limited to participants at volunteer sites set up by the IRS.
- The amount and degree of information/data that can be accessed from DOR over the Internet will be very limited at first and comparable to the information available via the Call Center. More detailed information is usually requested in writing. Requests for and access to more detailed information via the Internet, whether State or taxpayer-initiated, will be governed by C2 (low-level security) and IRS guidelines.
- Mr. Rowand was uncertain if there were federal guidelines limiting the amount and degree of information that can be disclosed via telephone.
- Mr. Rowand indicated that, at this time, there do not appear to be any technology security issues that could be facilitated via legislation.

Co-Chairman Hatch-Miller invited the attendees to submit their contact numbers and addresses if they would like to receive updates on agendas and minutes for the Committee. Mr. Hatch-Miller noted that today's meeting would focus on the integrity and security of data/information and e-commerce. He announced that the Committee will be addressing the six focus areas (infrastructure, security, regulation, privacy, taxation, and jurisdiction) in the form of subcommittees, and he invited the Members to make their assignment preference known on the sign-up sheet being circulated.

Co-Chairman Hatch-Miller announced, to the Members, that Janet Fischer is the contact person at the Arizona Library & Archives, located in the Capitol annex (602/542-3701), for resource materials. He noted that she and her staff have already begun collecting pertinent materials.

Mr. Kelly briefly previewed and circulated the following handouts: Electronic Signature in Arizona – Where do we go from here? (Attachment 1), Statewide Information Management Policy (Attachment 2), Information Security Policy (Attachment 3), and Information Security in State Government Information Technology (Attachment 4).

Tim Yopp, President/CEO, Palo Verde Software; Founder, Information Technology Association of Southern Arizona (ITASS), explained that it is "probably impossible" to secure anything on the Internet. He stated that, along with professional hackers who are attempting to break into networks, industry must guard against the internal threat of espionage and disgruntled employees.

Mr. Yopp noted that hackers are typically young males who are mischievous though not malicious. He added that the hacking of most concern now and in the future will occur between foreign governments, corporations and financial institutions. In a "study," conducted by Dan Farmer in 1996, Mr. Farmer attempted to breach the security of 500 business Internet sites in the United States. Of those 500 sites, Mr. Farmer was able to break into 60 percent of them and was able to "take down" 30 percent of them, if he chose. Mr. Yopp commented that there is a growing population of businesses that are eager to participate in the Internet yet do not know the first thing about Internet security, let alone the importance of it. In this way, Mr. Yopp drew a comparison between quality and Internet security: businesses talk about them a great deal yet they are the last thing they think about.

Mr. Yopp pointed out that cyber crime is undefined, which leaves local law enforcement at a loss. For example, what is the value of information (e.g., a customer list) if it is stolen?

Mr. Yopp speculated on the future of e-commerce and stated that most of it will be centralized: a few states will dominate travel agent sales and other states will dominate all electronic-loan commerce. Price wars will drive these service centers out of the country. However, Mr. Yopp contends that Arizona, with its better-than-average infrastructure, holds a good position to take advantage of this emerging commerce. For these reasons and others, internet security is an issue that the State must take seriously.

Representative Wong suggested that the Committee maintain communication with the technology groups in Southern Arizona, as they appear to be proactive and keeping pace with the evolution of e-commerce.

Representative Leff commented that, at a recent legislative convention, industry representatives requested legislators to maintain a hands-off approach, with respect to proposing and creating Internet legislation. She asked Mr. Yopp if he would address that point. Mr. Yopp explained that the evolution of security and technology, with respect to the Internet, is progressing seven times the speed as other industries. As a result, what is currently trend setting, will be outmoded and literally obsolete within a calendar year. With this in mind, and understanding the slow, laborious process of creating and implementing legislation, to regulate the Internet industry would be fruitless, if not counterproductive.

Mr. Yopp iterated that a great deal of potential and future crime/theft will occur between businesses. Furthermore, the many facets of cyber crime have yet to be addressed from a law enforcement perspective. Mr. Yopp suggested that any legislative intervention would be best spent in the realm of creating a centralized agency to which cyber crimes may be reported and through which cyber crimes may be pursued.

Senator Bennett asked for clarification of how Internet theft differs greatly from non-Internet theft. Mr. McNulty explained that there are Internet crimes (e.g., spoof attacks and logic bombs) that do not gain something for one party as much as cause damage to another. He concurred that law enforcement is utterly ill prepared to diagnose Internet crime, let alone treat it. Mr. Yopp suggested providing funds for a centralized unit that could assist local law enforcement in the realm of cyber crime. Mr. McNulty agreed that, at this stage of combating cyber crime, the issue is a matter of resources.

Representative Wong asserted that a great deal of cyber crime can be extrapolated into existing law and that it is a matter for the Attorney General's Office to update the criminal code. With regard to Ms. Leff's suggestion to license e-commerce businesses, Mr. Wong expressed hesitation and stated that he is concerned that such action may be injurious to an emerging industry. He suggested that the adage "buyer beware" is appropriate, even in the realm of e-commerce. Ms. Leff clarified that she did not want to see forms of e-commerce (such as real estate sales) occur on the Internet by an unlicensed individual, when the same sale, in the real world, would require a license.

Gail Thackery, Attorney, Arizona Attorney General's Office, stated that she has been prosecuting hackers since 1973 when she was still in law school. With this in mind, she has yet to see a computer security system that "works." Even the military gets hacked and they are supposed to have state of the art security. Ms. Thackery impressed upon the Committee that hackers are a unique breed of criminal. What other criminal society, she asked the Committee, holds and videotapes annual conventions, sells T-shirts, invites the press in addition to those who seek to prosecute them for their criminal activities?

Ms. Thackery explained that the motivation of a hacker is not inherently criminal; however, in attempting to hack into sensitive and critical networks, such as the network to a hospital, hacking does rise to a reckless and criminal level. She stressed that the aforementioned example is not fanciful but actual. In fact, she noted that the "hospital network investigation" of Summer 1986 revealed hacking activity taking place at Bell South and demonstrated how "completely insecure the entire telephone structure of the country" was. Ms. Thackery stated that she will deliver a packet to the Members that outlines incidents related to the proposed legislation the Attorney General's Office will be advocating for during the upcoming legislative session.

Ms. Thackery informed the Committee that there is a computer unit in the Department of Public Safety; however the highly-trained officers in this unit are expensive to train and expensive to equip. Combating computer crime effectively will require greater resources. Ms. Thackery explained that the window between detecting computer crimes and apprehending the hacker is by necessity a very short period of time, typically days.

A video clip of a recent hacker convention was shown to the Members. The video clip depicted a hacker addressing a large audience and presenting a new hacker software product that would enable a person to remotely control another persons computer without their knowledge.

(Tape 1, Side B)

Representative Wong agreed with Ms. Thackery that there is a real need to upgrade the criminal code. Additionally, he agreed that there is a need for greater resources to secure and train those with expertise in combating computer/cyber crime. He suggested that a cyber crimes unit, such as exists for gang crimes, might be created to maximize resources and address this growing problem.

Ms. Thackery indicated that she supports such a model – specifically, a cyber crimes unit – and stated that she has heard similar models implemented with success. For one reason, there is a synergy that arises when many people are working together to combat cyber crime, as opposed to one person in each agency. Ms. Thackery noted that such a unit would require a statewide appropriation.

Representative Wong commented that once the State makes a commitment and an appropriation to establish a cyber crimes unit, it would be wise to expect a cyber war, i.e., retaliation from the hacker community. He insisted that it will be important for the State to be both aggressive and defensive.

Steven Ellis, Director, Security and Privacy Policy, Intel, presented *Internet Security: An Industry Perspective* (Attachment 5). In response to questions posed by the Committee, Mr. Ellis added:

- Increased security, in terms of product development, is a component of research and development at Intel.
- Security is different than privacy. In some cases, increased security, reduces anonymity.
- The security benefit of the Pentium III microprocessor has been targeted for the business environment.
- Intel, Microsoft, and Sysco have lobbied actively on issues of encryption and, within the committee process, have collectively addressed security issues.

Representative Wong drew a parallel between the automotive industry and the management information systems industry. Specifically, with automobiles, safety became a hot button issue last, after fashion and convenience-related options. Similarly, in the realm of computers, now that great strides have been made in hardware, software, performance, and memory capacity, security is now becoming the hot button issue.

Co-Chairman Hatch-Miller speculated that financial institutions would probably be interested in increased computer security. Mr. Ellis explained that financial institutions are still primarily on private networks; however, as they move towards Internet-based banking, there will be a greater demand for security, both from the financial institutions and their customers. To a degree, Intel has worked with computer manufacturers and consumer groups on this and other emerging issues.

Mr. McNulty asked Mr. Ellis if he was paying attention to California's movement towards designating a digital certificate authority to be the official state agent to process and validate signatures. Mr. Ellis indicated that he is somewhat familiar with that. Mr. Kelly suggested two contacts for Mr. Ellis on this subject: Michael Tothorow, Chief Information Officer, Secretary of State's Office, and Linda Meissner, Telecommunications Policy Analyst, GITA. Mr. Kelly indicated that Arizona will be moving in a similar direction as and will be learning from California's success.

Russell D. Smoldon, Manager, Government Relations, Salt River Project (SRP) introduced John McKee.

Joe McKee, Principal Electrical Engineer, Network Management, Salt River Project (SRP), recounted how SRP was the victim of a breach of security approximately five years prior. Mr. McKee explained that SRP had defended itself from potential Internet attack and yet failed to safeguard its dial-in line, which was connected to the VAX VMS computer system that runs the canals. Mr. McKee noted that the Attorney General's Office notified SRP of the security breach; they were wholly unaware of it.

In response to the incident, SRP improved its frontline security (i.e., the firewall), issued a policy where the dial-in phone lines would terminate unless protected by approved methods (e.g. challenge response protection), and decreased the number of phone lines. Additionally, network intrusion software has been installed that "looks" for unusual activity and then investigates anything that warrants attention. In response to recent viruses, SRP has installed MacAfee's and Norton anti-virus software, and installed a unit that resides between the firewall and the exchange server for the purpose of monitoring incoming and outgoing e-mail for viruses.

Mr. McKee noted that he has attended hacker conventions and is aware of what he is up against. Additionally, Mr. McKee pointed out the implications of SRP being classified as "key infrastructure" by legislative analysts in Washington, D.C. In the event of warfare or terrorism, SRP might likely be a target for foreign attack. These potential threats, Mr. McKee explained, are taken very seriously by SRP, which continues to improve its level of computer security.

Mr. McKee explained that SRP has made efforts to publish a policy that informs all employees that any work-related information or access is the property of SRP. The legal department made this request so that any espionage would not go unpunished because SRP failed to exercise "due diligence" in outlining a breach of security. Mr. McKee acknowledged that as long as SRP is connected to the Internet its network will be a target for hackers.

Representative Wong suggested that Interpol may have an international cyber crimes unit. He asked if such international cyber crime might be economic driven. Mr. Yopp informed the Committee that there is a great deal of international software espionage occurring.

Mr. McKee described further safeguards SRP has taken to protect itself from viruses transmitted via e-mail and other shared media.

Lee Lane, Statewide Security Manager, Arizona Department of Administration (ADOA), presented a prepared statement (Attachment 6).

Mr. Kelly noted that there are over one hundred different state agencies and he asked Mr. Lee what kind of problems this presents to the Committee as it attempts to ascertain their security needs. Mr. Lee suggested that the Committee might have to consider establishing over one hundred different security systems; that security must, by necessity, be individualized.

Ken Behringer, Staff, Legislative Council, circulated and reviewed a comparative chart on state computer crime statutes (Attachment 7).

Representative Wong asked Ms. Thackery to describe the punishment of computer crimes. Ms. Thackery explained that computer crime is categorized as white-collar crime and that if a person has not prior criminal history, the punishment is usually probation. However, sentencing for computer crime can be as a Class III felony which carries a potential prison sentence. Ms. Thackery noted that it is very rare for an individual to go to jail for a first-time offense of computer crime.

Mr. Behringer noted that the provisions (Attachment 7) do overlap to some extent.

Co-Chairman Hatch-Miller stated that a goal of the Committee is to look at existing statutes and see if they cover modern security issues adequately.

Without objection, the meeting adjourned at 4:30 p.m.


Seth Goodman, Committee Secretary

(Original minutes, attachments, and tapes are on file in the Chief Clerk's Office.)

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10/1/99

10-1

**ARIZONA HOUSE OF REPRESENTATIVE
Forty-fourth Legislature – First Regular Session**

**STUDY COMMITTEE ON INTERNET PRIVACY,
JURISDICTION, REGULATION AND TAXATION**

Minutes of Meeting
Wednesday, October 6, 1999
Senate Appropriations Room #109 – 2:30 p.m.

(Tape 1, Side A)

The meeting was called to order at 2:37 p.m. by Co-Co-Chairman Hatch-Miller. The attendance was noted by the secretary.

Members Present

Senator Bundgaard, Co-Chairman
Senator Bennett
Senator Mitchell
Michelle Ahlmer
The Honorable Chris Bavasi
John Kelly
Michael McNulty

Representative Hatch-Miller, Co-Chairman
Representative Norris
Representative Valadez
Representative Wong
Peter Charlton
Dr. William E. Lewis

Members Absent

Senator Cunningham
Senator Spitzer

Representative Leff

Speakers

Don Isaacson, Legal Counsel, Arizona Licensed Beverage Association
Myron Musfeldt, Chief, Investigations, Department of Liquor Licenses and Control (DLLC)
Ken Behringer, Senate Analyst
Gail Thackery, Attorney, Arizona Attorney General's Office
Mariana Silveira, Project Coordinator, E-commerce, National Law Center for Inter-American Free Trade
Jeff Kulaga, Lobbyist, Arizona League of Cities and Towns (ALCT)
Stuart Forsyth, Executive Director, State Bar Association (SBA)
Janet Fischer, Director, Research Library, Arizona Library & Archives

Co-Chairman Hatch-Miller announced that assignments have been made for the subcommittees of the Study Committee on Internet Privacy, Jurisdiction, Regulation and Taxation (IPJRT) (Attachment 1).

Senator Bundgaard moved that a Subcommittee on Internet Security be formed with the initial membership of:

**Representative Leff
Representative Wong
Peter Charlton
John Kelly
Dr. William E. Lewis**

The motion carried.

Senator Bundgaard moved that a Subcommittee on Internet Infrastructure be formed with the initial membership of:

**Representative Valadez
Representative Wong
Peter Charlton
John Kelly
Dr. William E. Lewis
Michael McNulty**

The motion carried.

Senator Bundgaard moved that a Subcommittee on Internet Jurisdiction be formed with the initial membership of:

**Senator Mitchell
Mayor Chris Bavasi
Michael McNulty**

The motion carried.

Senator Bundgaard moved that a Subcommittee on Internet Regulation be formed with the initial membership of:

**Representative Valadez
Senator Bennett
John Kelly
Michael McNulty**

The motion carried.

Senator Bundgaard moved that a Subcommittee on Internet Taxation be formed with the initial membership of:

**Representative Valadez
Representative Wong
Senator Bennett
Senator Cunningham
Senator Mitchell
Mayor Chris Bavasi**

The motion carried.

Senator Bundgaard moved that a Subcommittee on Internet Privacy be formed with the initial membership of:

Representative Norris

Senator Cunningham

John Kelly

Dr. William E. Lewis

Michael McNulty

The motion carried.

Dr. Lewis noted that the Members of the individual subcommittees would be in contact with each other via e-mail. He requested that these Members include all 16 Members of the full Committee in their e-mail correspondence so that everyone remains fully informed.

Co-Chairman Hatch-Miller briefly outlined the subcommittee process:

- Subcommittees will investigate an assigned topic, making use of focus groups and roundtable discussions.
- The findings of the subcommittee will be returned to the full committee.
- The recommendations of the full committee will then be forwarded to the Governor's Office and the Legislature.

Co-Chairman Hatch-Miller explained that subcommittees are responsible for framing their assigned topic in executive summary format and deciding what principals ought to be adopted and recommended by IPJRT. He stated that the subcommittees will receive resources and examples to assist them in their charge.

Co-Chairman Hatch-Miller prefaced the discussion on Internet regulation with the notion that professions (e.g., attorneys) and products (e.g., liquor) that are traditionally controlled by licenses are now also available and actively marketed via the Internet, oftentimes, without such safeguards.

Don Isaacson, Legal Counsel, Arizona Licensed Beverage Association, explained that, after the states emerged from prohibition, they were able to adopt one of two models in the regulation of liquor. One option was that a state could take complete control, including ownership, of the liquor stores. The other regulatory option, which was adopted by Arizona, is called a three-tier system, in which the producers, wholesalers and retailers of liquor products must be licensed. Recent increases in electronic commerce (e-commerce), particularly with wine sales, have challenged the regulatory process. Any time an individual buys liquor from another state, both the seller and the purchaser are violating Arizona state laws. Mr. Isaacson iterated that this problem is not a result of the Internet, but rather the Internet has accelerated an issue that existed in other forms.

Mr. Isaacson noted that H.B. 2415 (direct shipment of alcohol; felony), which emerged from the 44th Legislature, 1st Regular Session, affirmed Arizona's three-tier system. Additionally, it made it possible for residents to purchase liquor from other states as well as gave out of state producers, wholesalers, and retailers access into the Arizona market. He noted that, eventually, the commerce of buying liquor outside of Arizona will appear seamless to the Arizona resident. The most important part of this equation, Mr. Isaacson explained, is the component of luxury

taxes, of which the State collects approximately \$50 million per year from both liquor and tobacco. Under the current, three-tier system, it is very easy to collect these taxes from the small number of wholesalers who are bonded. However, out-of-state vendors have been able to operate outside of the system, to the detriment of the Arizona liquor industry and the State coffers. This is the point that the licensed retailers take issue with.

Mr. Isaacson indicated that one remedy would be to create a level playing field, as has been attempted with H.B. 2415; however, having only been in effect for two months, it has yet to prove itself effective. Theoretically, outside vendors would need to sell their product through Arizona retailers so that taxes are collected and marketplace equity is ensured. Mr. Isaacson noted that a similar item of legislation is currently making its way through Congress, though not without challenge, which will allow the states' attorneys general to enforce local liquor restrictions.

Co-Chairman Hatch-Miller commented that, in this case, the commerce of liquor is being used illustratively and that the issues being brought to light would apply to the sale of other products that the state has control over (e.g., pharmaceuticals).

Myron Musfeldt, Chief, Investigations, Department of Liquor Licenses and Control (DLLC), related the evolution of Beer Across America, a private company, and the advent of selling and distributing beer products from microbreweries to consumers across the country. Mr. Musfeldt explained that, under Arizona's three-tier system, this form of commerce is illegal. In the case of Beer Across America, DLLC explained the manner in which their business could be conducted within Arizona state statute, and for three years they were the only such business that was in compliance.

Mr. Musfeldt explained that, typically, a non-compliant vendor is brought to the attention of DLLC by an Arizona wholesaler or retailer or some form of advertisement and DLLC issues a cease and desist order or warrant a fine not to exceed \$150,000. At this point, vendors are usually cooperative. Mr. Musfeldt clarified that most vendors are simply ignorant or unaware of Arizona statutes or the fact that they may be operating outside of the law. Mr. Musfeldt stated that he has yet to come across an out-of-state vendor who wants to break the law. Further, when DLLC has made test calls to some out-of-state vendors who are not able to sell to Arizona residents, they tend to be good at policing themselves and will decline the sale.

Mr. Musfeldt referred to the aforementioned federal law that enables a state's attorney general to enforce the interstate sale of liquor, and stated that it will be useful when an out-of-state vendor challenges DLLC's jurisdiction. With regard to pursuing out-of-state vendors, Mr. Musfeldt iterated, DLLC usually relies on the watchdog efforts of local liquor wholesalers and retailers.

In response to questions posed by the Committee, Mr. Musfeldt added:

- There are no jurisdictional problems with Germany or other nations, with regard to the illegal sale or distribution of liquor.
- Questions regarding excise tax on liquor products bought via the Internet and the moratorium on Internet taxation ought to be directed to the Luxury Tax Division of the Department of Revenue.

- Arizona is one of many states that adopted the three-tier system; however, Arizona was one of the first states to delineate in statute how to gain access to the local liquor market.
- Liquor arriving from out-of-state must not only "bump the dock," it must also be unloaded and sit for 24 hours before it is considered in the state for the purposes of sale. Out-of-state liquor may not be shipped directly to the consumer in Arizona, as it is not a purely paperwork process.

Dr. Lewis referenced a recent newspaper article (*The New York Times*, Monday, October 8, 1999, Section C-18) (Attachment 2), with regard to the Internet Tax Freedom Act in response to the point on excise tax on liquor sales (or any sales, for that matter) via the Internet.

Ken Behringer, Senate Analyst, framed the issue of jurisdiction, specifically, the authority of the State of Arizona or its courts to act over non-residents. In the context of the Internet, Mr. Behringer explained, there is confusion as to how Arizona residents might bring suit against a remote defendant, as well as how Arizona citizens might be called into the courts of other states. In the event that e-commerce is conducted between residents of Arizona and Alaska, who must travel to which state?

Mr. Behringer explained that there are two constitutional components to jurisdiction. The first component, the long arm statutes [Court Rule 4(e)(1) and (2)], provide that a person, corporation or organization that has caused an event (that warrants a lawsuit) to happen in Arizona comes under its jurisdiction. Further, the statutes define when a non-resident person or corporation may be sued in Arizona courts. Mr. Behringer noted that, from a policy standpoint, the Legislature might wish to consider the degree of regulation it wishes to uphold, whether it be full regulation or something less. The second constitutional component speaks to the limitations of a state, specifically the due process burden a state has to establish jurisdiction. In the realm of the Internet and e-commerce, jurisdiction will need to be revisited and perhaps redefined.

Mr. Behringer presented court decisions on jurisdiction as well as contemporary interpretations of jurisdiction for the purposes of Internet e-commerce (Attachment 3). In response to a question posed by Mr. Kelly, Mr. Behringer indicated that junk e-mail ("spam") would qualify as a level of interactivity deemed sufficient to establish "minimum contact." However, with respect to a website, the degree of interactivity can be more difficult to ascertain.

Representative Wong asked if the courts, in general, have ruled on this issue or if it remains in the realm of legal analysis. Mr. Behringer indicated that there have been a number of court cases and rulings on this particular issue. Representative Wong commented that he will follow the issue with great interest as it is likely to come before the United States Supreme Court in the near future.

Mr. Behringer noted that, at their last convention, the National Conference of State Legislatures (NCSL) opposed a provision that would allow a state attorney general from enforcing laws beyond the state's jurisdiction. Specifically, NCSL took issue with the inappropriateness of federal courts dealing with state law issues. This provision was contained in the aforementioned Congressional legislation discussed by Mr. Isaacson. Additionally, there exists proposed legislation in Congress that would seek to prevent/pre-empt states from establishing a standard for electronic signatures until one is established by the National Conference of Uniform State Laws.

(Tape 1, Side B)

Gail Thackery, Attorney, Arizona Attorney General's Office, stated that there is another aspect to Internet crime that impacts the public safety of the citizens of Arizona. Specifically, Ms. Thackery explained, Arizona business law has presented some challenges to investigating Internet crime because it lacks uniformity with regard to framing "sufficient minimum contact."

Ms. Thackery noted the absence of an established standard for compelling an out-of-state business to answer a subpoena or respond to a warrant. Such limitations can be detrimental when, for example, dealing with e-commerce fraud or, in a recent case, when a fugitive kidnapper is communicating via the Internet.

Ms. Thackery explained that, with regard to jurisdiction, telephone communiqués are, by their very nature, interstate commerce when made from state to state. Ironically, the only individuals barred from gaining information, via subpoena, about Internet accounts are government employees; specifically, law enforcement. However, a private attorney may file a subpoena for records, which would appear to sufficiently motivate any private corporation. Such inequity is a result of the wire tap laws and the Electronic Communication Privacy Act. Without an industry standard to go by, requests for records must be done on a case-by-case basis. Though, for example, AT&T certainly does business in Arizona and has a presence in the State, if their Internet server is located in California, they may flatly refuse a subpoena issued from an Arizona court. Many remote businesses, however, will accept a grand jury subpoena when it is faxed because they recognize that they participate in national commerce.

What further complicates the process, Ms. Thackery continued, is that most Internet and e-commerce records are permanently deleted within 48 hours. Although some companies retain records for a longer period of time, there is no requirement in place to do so other than what serves the billing needs of the company. Now that many companies offer free e-mail service and neither insist on accurate identification information, nor maintain permanent records of their activities, tracking the criminal element in cyberspace has become more challenging. In many cases, if a business or Internet provider does not have an office that is physically in the State of Arizona, they may refuse a subpoena. Even America Online, which has a Tucson office, refused a warrant, indicating that a warrant must be served in the state of their home office by an officer working in that state. With records disappearing within 48 hours, Ms. Thackery insisted, such challenges seriously and unnecessarily challenge the charge of law enforcement officers. Ms. Thackery asserted that many businesses that conduct commerce in the State of Arizona refuse to honor the process of Arizona law enforcement.

Mr. McNulty noted that America Online motivated Virginia, the state in which it is based, to adopt legislation that granted stronger jurisdiction to Virginia courts. He asked Ms. Thackery if she might foresee America Online making an objection if Arizona were to follow suit. Ms. Thackery could not say for certain. She noted that one factor to consider is the role of Internet "carriers" who claim that they are "startup companies" and, as such, might resist law enforcement. Ms. Thackery contends that these startup companies must be held to a same or similar standard of accountability as their affiliates. Additionally, Ms. Thackery asserted that law enforcement must continue at the state level, as there will never be enough federal law enforcement to handle the volume of Internet crime or trespass.

Ms. Thackery noted that California passed an item of legislation that required out-of-state businesses to have a person and address to accept process. This step, she suggested, might set a precedent and benefit the entire country. Ms. Thackery stressed the critical nature of this point, the ability of states to protect its citizenry, especially as more and more business is conducted by corporations from remote locations in the country or even the world. She asked the Committee to consider a hypothetical situation in which a foreign company purchases a local phone system: where would the records be kept and how accessible will they be? Further, what degree of security will these records maintain?

Mariana Silveira, Project Coordinator, E-commerce, National Law Center for Inter-American Free Trade, a non-profit organization, related the establishment of the Law Center and its purpose, with regard to e-commerce and Latin America. Ms. Silveira highlighted the recent 2-day conference held in Tucson, which focused on analyzing the practices and customs of government and private-business sectors throughout the countries in the Americas. Ms. Silveira noted additional issues that were raised at the 2-day conference:

- Blocks to effective expansion of e-commerce among the Americas was analyzed.
- Issues of regulation were explored; specifically, government regulation and deregulation, and self-regulation by the private sector. On this point, there was little consensus.
- The panelists adopted the principals of "freedom of contact," and "various applicable law," and "applicable jurisdiction," which essentially charges participants who engage in e-commerce to be fully informed buyers and sellers, know the rules and accept the risks. Restricted autonomy and the issue of jurisdiction continue to be controversial.
- In Latin America, with regard to electronic signatures and e-commerce in general, there are no rules that are in place. For this reason, emerging e-commerce must be processed on a case-by-case basis.
- A resolution was reached to have structured work groups that will study the issues in further detail. It is hoped that the private sector and government representatives of the various countries will participate jointly in these committees. The anticipated foci of these groups will be contracts, jurisdiction, intellectual property, banking and finance transactions, and regulatory issues.

Ms. Silveira stated that she would be happy to keep the Committee updated on the progress of these work groups. Additionally, she invited the Members to offer their input and cooperation in the ongoing work of the Law Center.

Co-Co-Chairman Hatch-Miller stated his understanding that the various nations would like to adopt resolutions to harmonize the mechanisms of e-commerce. Ms. Silveira concurred. Co-Co-Chairman Hatch-Miller further stated his understanding that it is a general consensus that such harmonization ought to be handled via international treaty. Ms. Silveira agreed that such was a conclusion reached at the recent conference for the purpose of creating general rules that would avoid the dangers of over-regulation. Additionally, Ms. Silveira relayed the consensus that for such an international treaty to be successful, the judicial systems of the many governments must be "sufficiently trained."

Jeff Kulaga, Lobbyist, Arizona League of Cities and Towns (ALCT), noted that the issue and question of jurisdiction and regulation and how it applies to cities and towns is difficult to answer. However, it does seem that the cyber world is dismantling historical, geographical boundaries. Mr. Kulaga discussed the following points with regard to Internet jurisdiction and regulation:

- The taxation moratorium established by the Internet Tax Freedom Act is a concern to Arizona cities and towns, as it is with cities and towns throughout the country.
- In a recent study of taxation, a professor at the University of Arizona bought the same computer from three different vendors: a Best Buy located in Tucson, Dell via mail order, and Insight.com via the Internet. The inequity was readily apparent. There is a concern by Arizona cities and towns that such mismatched taxation might create active tax avoidance.
- The National League of Cities and Towns (NLTC) will be monitoring the affect on various taxes generated by the Internet Tax Freedom Act; specifically, Internet access fees, discriminatory taxes, local taxes and volume taxes.
- ALCT has forecasted a potential loss of \$103 million in retail taxes by the year 2003, as a result of e-commerce. For this reason, NLTC will be asking Congress to execute a level playing field and ensure a fair and equitable tax no matter how, for example, a person buys a personal computer.
- ALCT has concerns as to how emerging e-commerce will geographically affect our current town squares and hubs of commerce, such as malls and downtown city blocks.
- Statistically speaking, 80 percent of homes earning \$75,000 annually own a personal computer while only 15 percent of homes with an annual income of approximately \$20,000 own a personal computer. Considering that there is a great deal of low-cost merchandise being made available via the Internet and considering the aforementioned statistics, ALCT has concerns regarding the inequity of this emerging "digital divide"
- ALCT is cognizant of the complexities inherent in connecting the jurisdictions of cities, towns, states, federal governments, and foreign nations.
- There are unresolved issues with regard to Internet access at local libraries; specifically, for example, what does or does not constitute pornography, which will vary from community to community.
- There is a growing concern over Internet scams and fraud, particularly as it affects senior citizens.
- ALCT has concerns over its ability to finance local law enforcement to battle the growing incidents of computer crime. To this issue, ALCT would look to partner with state and federal agencies to successfully challenge such sophisticated criminal activities.
- ALCT requests that, as the state begins to actively legislate in the realm of e-commerce, that it "have a place at the table to help draft the most effective solutions."

Mr. Wong commented that, with the emergence of catalog and mail order sales, there was concern from ALCT that their tax-generated income would be greatly affected. He asserted that there is a strong similarity between catalog sales and e-commerce and he requested that the Committee be provided the arguments raised by ALCT during that time period. Mr. Kulaga stated that he would provide that material to the Committee.

Mr. Kelly noted that there are many valid concerns that ALCT has, with regard to Internet jurisdiction and regulation. He asked Mr. Kulaga if any positive benefits have been forecast by

ALCT as a result of expanding e-commerce. Mr. Kulaga conceded that e-commerce brings with it many wealth and economic opportunities for cities and towns; however, adequate telecommunications infrastructure must be in place to capitalize on such opportunities.

Stuart Forsyth, Executive Director, State Bar Association (SBA), commented that, in the accelerated flow of information and commerce, time and place are becoming less relevant. Furthermore, the acceleration appears to be exponential. This climate has moved the citizens of Arizona, individually and collectively, to be more global, more diverse, more demanding, and more sophisticated.

Mr. Forsyth noted that Arizona is one of the few states that do not prohibit the unauthorized practice of law. In most every other state, such unauthorized practice is regarded as a felony or misdemeanor. Anyone, Mr. Forsyth asserted, can come into Arizona, say they are a lawyer, and practice law.

SBA is actively putting on workshops to train its members on the use of the Internet (e.g., how to conduct research, among other things). Additionally, SBA has provided e-mail forwarding service to its members to encourage greater involvement with the emerging technology, especially for older attorneys. Currently, approximately 2,400 SBA members have taken advantage of this service. Additionally, SBA has worked to build a comprehensive database of its membership so that a potential client may search, via the ABA web page, for an attorney that meets their specific criteria. Furthermore, SBA is actively working with the Government Information Technology Agency (GITA) and the Office of the Secretary of State to develop viable mechanisms for digital certificates. Such digital certificates would confirm one's authority to practice law via the Internet at the time of service.

Mr. Forsyth noted that precedents have been set for the transition our culture is currently experiencing and he encouraged the Members to read the following two books:

- *The Machine in the Garden: Technology and the Pastoral Ideal in America*, by Leo Marx
- *The Victorian Internet: The remarkable story of the Telegraph and 19th Century's On-line Pioneers* by Tom Standage.

Mr. Wong asked Mr. Forsyth to comment on the execution of basic contracts in an electronic format. Mr. Forsyth asserted that the laws that govern such contracts must be uniformly commissioned by a national, if not international, standard.

Janet Fischer, Director, Research Library, Arizona Library & Archives, informed the Committee that the Research Library staff has compiled a resource list for the benefit of the Members and that it continues to be updated as more information is gathered. Ms. Fischer distributed a map to and of the Research Library (Attachment 4) and reminded the Members that she and her staff are at their service.

Mr. Charleton announced that Vinton Cerf, Vice President, MCI WorldCom and "Father of the Internet," will be speaking publicly in Phoenix on November 22, 1999 at 8:00 a.m. and he stated that he would attempt to arrange a special meeting with Mr. Cerf and the Committee.

Without objection, the meeting adjourned at 4:29 p.m.



Seth Goodman, Committee Secretary

(Original minutes, attachments, and tape are on file in the Chief Clerk's Office.)

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10/18/99

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ARIZONA STATE LEGISLATURE
Forty-fourth Legislature – First Regular Session

**STUDY COMMITTEE ON INTERNET PRIVACY,
JURISDICTION, REGULATION AND TAXATION**

Minutes of Meeting
Wednesday, October 20, 1999
Senate Appropriations Room #109 – 2:30 p.m.

(Tape 1, Side A)

The meeting was called to order at 2:37 p.m. by Co-Chairman Hatch-Miller. The attendance was noted by the secretary.

Members Present

Senator Bundgaard, Co-Chairman
Senator Cunningham
Senator Mitchell
Senator Spitzer
Michelle Ahlmer
The Honorable Chris Bovasi
Dr. William E. Lewis

Representative Hatch-Miller, Co-Chairman
Representative Leff
Representative Norris
Representative Valadez
Representative Wong
John Kelly

Members Absent

Senator Bennett
Michael McNulty

Peter Charlton

Speakers

Larry Pike, State Director, Office of Senator John McCain
Dr. Janice Brundage, representing herself, Tucson
Llyn A. Lloyd, Executive Director, Arizona State Board of Pharmacy
Paul Walker, Legislative Liaison, Arizona Department of Gaming (ADOG)
Melodie Jones, House Research Analyst
Len Munsil, President, Center for Arizona Policy
Deanna Conn, Streich Lang
Carder Hunt, City of Scottsdale
John Badal, Arizona Competitive Telecommunications Coalition
Mary Ellen Gleason, US West
Oris Friesen, Phd., Chairman, Arizona Telecommunication and Information Council (ATIC)
Mark Goldstein; President, International Research Center; Past Chairman and Board Member,
Arizona Telecommunication and Information Council (ATIC)
Steve Peters; Executive Director, Community Information and Technology Alliance (CITA);
Board Member, Arizona Telecommunication and Information Council (ATIC)

Guest list (Attachment 1).

Representative Norris moved that Michelle Ahlmer be included in the Subcommittees on Internet Taxation and Internet Privacy. The motion carried.

Representative Norris moved that Senator Spitzer be included in the Subcommittee on Internet Jurisdiction and Internet Privacy. The motion carried.

Larry Pike, State Director, Office of Senator John McCain, read a prepared statement from Senator McCain's Office (Attachment 2). Mr. Kelly asked Mr. Pike if he knew Senator McCain's position on the two competing proposals regarding general form electronic transactions. He indicated that he would get that information to Mr. Kelly.

Co-Chairman Hatch-Miller mentioned a rumor he had heard that there was a bill proposed in Congress, perhaps 409AA, in which the Postal Service would seek to charge a five-cent sales tax on every e-mail. Mr. Pike stated that he would attempt to track that bill down. Dr. Lewis informed the Committee that such a rumor is a confirmed Internet hoax.

Dr. Janice Brundage, representing herself, Tucson, presented an overview of telepractice and professional issues regarding psychologists (Attachment 3). Mr. Wong noted that Intel and the American Medical Association are developing Internet mechanisms that will allow a consumer to know, online and in real time, if the practitioner they are consulting with is who they say they are and licensed as they say they are.

Llyn A. Lloyd, Executive Director, Arizona State Board of Pharmacy, made a presentation on the subject of state regulation of Internet pharmacy practice sites (Attachment 4). In response to questions posed by the Committee, Mr. Lloyd added:

- The Internet will significantly change the way pharmacy is conducted.
- Established pharmacy regulations, such as those imposed on the neighborhood Walgreens, will not adequately address the issues of regulating cyber pharmacies.
- It is well noted that pharmaceuticals are being sold from other countries into America via the Internet, and then shipped from yet other country.
- There is an additional concern for those web sites that purport to be pharmacies by virtue of selling pharmaceuticals, when they are, in reality, warehouses of prescription medications, and have no connection to a legitimate pharmacy.
- How such warehouses get a hold of prescription medications is another issue.
- What particularly concerns the Arizona State Board of Pharmacy is that a person might log on to a pharmacy website, that is actually a warehouse of pharmaceuticals, and have access to prescription medication without having to produce a prescription. An additional concern is that diagnoses for prescription medications might be made via the Internet.
- Arizona mail-order pharmacies have been extremely responsible in the manner in which they conduct business. However, the laws that regulate such mail-order pharmacies will not adequately address the needs of Internet pharmacy regulation.

Paul Walker, Legislative Liaison, Arizona Department of Gaming (ADOG), presented a prepared statement regarding online gambling (Attachment 5). Senator Spitzer asked Mr. Walker if the provision in Title 13, making unlawful games of chance unless otherwise set forth in statute as legal, would adequately make Internet gambling illegal in Arizona. Mr. Walker stated that such is the analysis that ADOG is currently relying on.

Senator Spitzer commented that, because Internet gambling is illegal under State statute, it is therefore not a violation of tribal compacts. Additionally, any credit card transaction over the Internet for the purpose of online gambling would be, as interpreted under Arizona case law, void from their onset and therefore not subject of a valid debt. Senator Spitzer conceded that there is a statutory remedy needed; however, he characterized the issue as a law enforcement problem.

Co-Chairman Hatch-Miller directed the Committee Secretary to enter into the record a three-page letter written by Eleanor Eisenberg, Executive Director, Arizona Civil Liberties Union (Attachment 6).

Melodie Jones, House Research Analyst, summarized the content of Ms. Eisenberg's letter.

Len Munsil, President, Center for Arizona Policy, stressed the two following points, with regard to pornography and the Internet: 1) society has placed certain types of pornography outside of the protection of first amendment rights, and 2) existing laws on obscenity are sufficient to address Internet pornography.

(Tape 1, Side B)

Mr. Munsil cited a recent interview of upper middle-class teenagers in Georgia who contracted sexually transmitted diseases. The children, when asked why they were engaging in highly risky sexual activity, revealed that they were imitating what they had seen on videos. Furthermore, Mr. Munsil explained, pedophiles use pornography to desensitize children and "prepare" them for molestation. Additionally, areas where pornography is more widely available typically have a higher rate of rape.

Mr. Munsil iterated that laws are in place, with regard to contraband pornography, that place such material outside of the protection of first amendment rights, regardless of whether the source is illegal imagery, videotape, magazines, bookstores, or the Internet.

Representative Leff asked Mr. Munsil how law enforcement can effectively enforce pornography that is posted on elusive web sites. Mr. Munsil indicated that such difficulties pre-dated the Internet. He suggested that the sources be tracked down and vigorously and publicly prosecuted, including the purveyors of pornography, and this might create a disincentive for the majority of participants.

Representative Wong noted that, along with telemarketing fraud, some web sites are fly-by-night and very difficult to track down. He suggested creating a task force through the Attorney General's Office to assist law enforcement in addressing child pornography and gaming on the Internet.

Dr. Lewis noted that a great deal of such web sites emanate "offshore" and, as such, may be outside state, if not national, jurisdiction and therefore unenforceable.

Deanna Conn, Streich Lang, presented an overview of Internet regulation (Attachment 7).

Carder Hunt, City of Scottsdale, presented a PowerPoint presentation on the use of Internet technology in the City of Scottsdale (Attachment 8).

John Badal, Arizona Competitive Telecommunications Coalition, distributed a folder containing a prepared statement (Attachment 9), a packet of newspaper articles on telecommunications (Attachment 10), and a list of United States facilities-based telecommunications providers (Attachment 11). Mr. Badal presented from selected portions of his prepared statement (Attachment 9).

Representative Wong noted that, at one time, long distance companies such as AT&T were trying to access local networks such as US West, and asked if the current perception of long distance companies, with regard to local networks, is hypocritical. Mr. Badal suggested the current perception of local networks might be the result of competitive reaction. He explained that when AT&T attempted to access the local network, they found that "the hassle was too great, the red tape was too onerous," and the threat to their customer-service reputation was real.

Representative Wong asked Mr. Badal if he felt that companies like America Online (AOL) ought to be prohibited from accessing certain networks. Mr. Badal explained that companies like AOL can be accessed through the networks of their choosing, and if a customer wants to use another network (e.g., Cox Communications), for whatever reason, the customer would have to pay the additional service fee for accessing this other network. He added that AOL's approach to this connectivity dilemma is to suggest that the other network forego its service fee, while AOL collects its full service fee. Understandably, these other networks object to this remedy.

Mary Ellen Gleason, US West, briefly noted the manner in which US West has accommodated the growing need for network infrastructure in rural and metro Arizona. This infrastructure rivals that of many other major American cities and has been achieved through a process of partnership with large corporations and state government.

Ms. Gleason presented a series of slides (Attachment 12) that denote the use and expansion of US West services; specifically, frame relay, Internet Provider Services, and Asynchronous Transfer Mode technology, which accommodates the transmission of voice and video data.

(Tape 2, Side A)

Oris Friesen, Phd., Chairman, Arizona Telecommunication and Information Council (ATIC), explained that ATIC seeks to satisfy the telecommunication needs related to Internet electronic commerce (e-commerce). To this end, ATIC has undertaken to form the following four committees that relate to infrastructure development:

- Telecommunications investment for Arizona.

- Implications of digital signatures and e-commerce in Arizona (Formed in conjunction with other committees established under the Government Information Technology Agency and the Office of the Secretary of State.)
- Multi-tenant building access for Internet provider services, headed by Mark Goldstein.
- Implications of the US West rate case (i.e., the purchase of/merge with Qwest), headed by Steve Peters.

Mark Goldstein; President, International Research Center; Past Chairman and Board Member, Arizona Telecommunication and Information Council (ATIC); briefly framed the issues and challenges related to providing telecommunications services through the "last hundred feet" to consumers. This will initially be pursued via multi-tenant residential and commercial buildings, for economical reasons. He noted that the challenges of access mirror other debates. However, instead of AOL closing their access to Microsoft, landlords block access to those who want to connect the "last hundred feet" of telecommunications line. Landlords feel justified in being "gatekeepers" because of their ownership and applicable private property rights.

Mr. Goldstein noted that there is telecommunications access legislation being developed at virtually every level of government and that he, with his above-mentioned committee, intends to provide the Arizona Legislature with a benchmark study for the region and the nation on this issue (Attachment 13).

Steve Peters; Executive Director, Community Information and Technology Alliance (CITA); Board Member, Arizona Telecommunication and Information Council (ATIC); made the following points to the Committee:

- CITA understands that there will be no rate increase, as a result of the merge between US West and Qwest. However, if rates are increased, CITA would be willing to support an increase provided that it contributes to advancing telecommunications infrastructure, that the impact to existing infrastructure is disclosed, and that CITA is given the opportunity to evaluate the proposed increase.
- A high level of communication from US West and Qwest ought to be requested and expected as the proposed merge proceeds.
- With regard to US West selling off rural exchanges, the implications of these sales to education and economic development ought to be better understood.
- A new paradigm must be adopted, with regard to telecommunications companies. Rather than viewing them as "bad guys" who can be used to build up infrastructure in Arizona, they can be approached in terms of partnership, investment, and incentive. It would be beneficial to revisit licensing and franchise fees and the requirements for both, and encourage more enlightened policies at the local and state level.
- Today, the lines between business and residential telecommunications have become blurred because there is a tremendous amount of small business and telecommuting. This small business environment/trend needs to be supported and this merits a needs assessment. Perhaps a joint study between government, industry, and the State universities would be effective.

Without objection, the meeting adjourned at 4:45 p.m.



Seth Goodman, Committee Secretary

(Original minutes, attachments, and tapes are on file in the Chief Clerk's Office.)

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10/29/99

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ARIZONA STATE LEGISLATURE

STUDY COMMITTEE ON INTERNET PRIVACY, JURISDICTION, REGULATION AND TAXATION

Minutes of the Meeting
Wednesday, November 3, 1999 – 2:30 p.m.
Senate Appropriations Room 109

Members Present:

Representative Jeff Hatch-Miller, Co-chair Senator Scott Bundgaard, Co-chair
Representative Barbara Leff Senator Ken Bennett
Representative Ramon Valadez Senator Harry E. Mitchell
Michella Ahlmer, Arizona Retailers Association
The Honorable Chris Bavasi, Mayor of City of Flagstaff
Peter Charlton, MCI WorldCom
John Kelly, Director of GITA (Government Information Technology Agency)
Dr. William E. Lewis, ASU Information Technology

Members Absent:

Senator Marc Spitzer
Senator George Cunningham
Representative Debora Norris
Representative Barry Wong
Michael McNulty, Attorney-Tucson

Representative Hatch-Miller called the meeting of the Study Committee on Internet Privacy, Jurisdiction, Regulation and Taxation to order at 2:42 p.m. Attendance was noted. See attached list for other attendees (Attachment A).

OPENING REMARKS

Representative Hatch-Miller welcomed everyone to the fifth meeting of the Committee. He commented that a lot of ground had been covered and today's presenters would discuss infrastructure and taxation.

Lyle Williamson, Senior Manager, Public Policy, MCI WorldCom, indicated he would address infrastructure, jurisdiction and regulation. He indicated that Peter Charlton, a member of this Committee, represents MCI WorldCom in the Sales and Marketing Department in Phoenix. Mr. Williamson remarked he appreciated the approach the Committee is taking by having representation from the private sector and other agencies. He said the internet is a shared responsibility on the part of the industry as well as regulators and policymakers throughout Arizona, the country and the world. Mr. Williamson distributed a map

showing UUNET's (an MCI WorldCom Company) North American Internet network (Attachment B). and another document entitled "MCI WorldCom's Internet Policy Principles" (Attachment C). Mr. Williamson emphasized that MCI WorldCom is among the leaders in the industry and pointed out the map reflects the backbone network of their internet and long-distance infrastructure network in the United States and around the world. He referred to the tremendous growth in the international area that long-distance providers are experiencing, but indicated there are stumbling blocks coming from the local connectivity side of the infrastructure.

Mr. Williamson stated the higher-end business community is benefiting as far as utilizing the local to global to local network, however, the preference and challenge for MCI WorldCom is to have everyone connected. He said they are building out the fibers and working on other methods to utilize the technologies, such as cable network, fixed wireless and satellites. He said they are investing funds trying to get as much as the traffic on their own networks as possible, but there is seamless transfer traffic involving local telephone companies, MCI WorldCom's network and the other networks, which are basically unknown to the customer or end-user.

He said the technological innovations over the next five years will be greater than the past five years. Local telephone companies, such as US West and AT&T are also working towards improving the infrastructure and providing the speed that customers are demanding. He suggested as the policymakers are reviewing the whole issue, they need to keep in mind that with local connectivity everyone will benefit.

Mr. Williamson said MCI WorldCom developed Internet Policy Principles for the Committee's consideration and that Arizona is identified as a great potential for the whole industry. He said the greatest potential for MCI WorldCom and US West Communications is to offer the highest speed band width as quickly as possible through utilization on a non-discriminatory basis under the federal 1996 Telecom Act. He referred to the current on-going debates before the Federal Communications Commission, federal courts and other jurisdictions regarding usage of the Digital Subscriber Line (DSL) networks of the incumbent phone companies and the ongoing challenges of local connectivity. He welcomed questions or comments from the Committee.

Dr. William Lewis commented he was concerned about relying on US West's DSL, since currently they only reach twenty percent of the installed community in the greatest Phoenix area. Mr. Williamson replied MCI Worldcom is not only relying on DSL network, but they are also investing in fixed wireless and cable network for accessibility.

Representative Valadez wanted to know what is being done to address the issue of access to the internet and new technologies to the "have-nots" in terms of

infrastructure, the cost of computers and access of local connectivity. Mr. Williamson responded that twenty-five percent of homes in the country have computers with modems and most are fairly happy with their connectivity. MCI Worldcom is anticipating greater demand and with the policies in place would like to provide faster access to the internet by investments in local connectivity through fixed wireless and cable as well as the local telephone companies' investing in DSL technologies

John Bedell, representing Arizona Competitive Telecommunications and Coalition, commented that he gave a presentation at the last meeting, and offered to expand that presentation for the Committee. Representative Hatch-Miller indicated the Committee needed to proceed with the agenda, and if time allowed, Mr. Bedell could expound on his remarks at the conclusion of the meeting.

Barry Aarons, representing Americans for Tax Reform (ATR), commented he is a Senior Fellow with ATR, headquartered in Washington, D.C. He said the President of ATR, Grover Norquist, is a member of the U.S. Advisory Commission on Electronic Commerce, and that ATR is conducting hearings and will be submitting their recommendations to Congress for appropriate legislative action. He stated that ATR is a member of the E-Freedom Coalition and will be issuing its recommendations to the Commission next week in Washington, D.C.

Mr. Aarons remarked his topic is e-commerce taxation, and referred to the "third wave" of human history as defined by Alvin and Heidi Toffler in their seminal 1980 work of the same name, which revolves around an information-based, service-oriented society that bears little resemblance to the agricultural or industrial waves that have preceded. He said the United States is in a position of unparalleled leadership and in the forefront of its evolution, therefore, it is critical that the growth and leadership not be stifled.

Mr. Aarons referenced three documents:

1. An article written by Congressman Christopher Cox, which appeared in the Los Angeles Times on October 31, 1999.
2. A paper by Dean Andal, Vice Chairman of the California State Board of Equalization and a member of the US Advisory Commission on Electronic Commerce; and,
3. A paper by Orson Swindle, who is a member of the Federal Trade Commission.

Mr. Aarons indicated he wanted to premise his remarks with the overriding contention that enhancing capital formation and its resulting jobs creation is the critical consideration. He said if e-commerce is being viewed with the intention of determining how much revenue can be extracted, then the importance of e-commerce to our overall economic well being has been lost. He said the number

of small and medium sized businesses that have evolved as a direct result of e-commerce expansion is astounding.

Mr. Aarons quoted from the above sources and commented he understands the fears that exist, especially among political subdivisions regarding their ability to raise revenues from an untaxed element of commerce that is drawing business away from revenue-producing walk-in retailing. He referred to the Study Committee that is reviewing the model city tax code and suggested the opportunity exists with both Committees to look forward rather than backwards on definitional approaches to consumption taxes.

Mr. Aarons urged the Committee to look upon the issue holistically and the entirety of e-commerce issue as it relates to taxation, at the economics of e-commerce as it relates to capital formation and jobs creation; and to move ahead with tax policies such as he has offered that will encourage e-commerce development in Arizona (Attachment D).

Terry Trost, Assistant Director, Transaction Privilege & Use Tax Division, Arizona Department of Revenue (DOR), commented on the status of the Advisory Commission on Electronic Commerce, which is a creation of the Internet Tax Freedom Act. He said the Commission sunsets on April 21, 2000, and its primary mission is to make recommendations on internet (remote) taxation to Congress. He indicated on December 14 and 15 in San Francisco, the Advisory Commission will be taking testimony of proposals regarding the future of taxation of internet commerce.

Mr. Trost commented on the proposal being pursued by the public sector outlined in his memorandum dated November 3, 1999 to the Committee (Attachment E). He stated the Federation of Tax Administrators, the Multi-State Tax Commission, the National Governors Association, the National Council of State Legislators as well as the League of Cities and Towns are working on a pilot test program that uses technology to solve the transactional tax issue. Mr. Trost explained the procedure of a remote sale vs. main-street sale and said the purpose of the proposal is to determine if there is an opportunity to overlay a brick-and-mortar tax approach until it becomes a search-and-click basis of commerce. Arizona is one of the model test states, because of the availability of a model city tax code, sections, and titles to assess the correct tax. He commented on the make-up of the Advisory Commission and said a two-thirds supermajority vote of the Commission is required to go forward to Congress.

Senator Bundgaard asked what the administration burden would be under the "zip plus four" concept. Mr. Trost replied the information was derived from Taxware International and explained that part of this concept is to overcome the accrual aspect of the administrative burden as an impediment to interstate commerce. He said the theory is that if the administrative burden is reduced to near zero, the U.S. Supreme Court's objection would be overcome and there

would be a nexus on an economic presence and not on a physical presence. He stated that in Arizona the current accounting credit would go to the vendor, the thirty-day float would go to the third party provider and it would offset a major portion of the cost.

Todd Brundrett, representing Norwood Furniture, a family-owned business, Gilbert, Arizona. As a part owner, he commented on internet taxation and how it affects their business. He distributed copies of the National Home Furnishings Association Washington Report, dated October 1999, Number 10, (Attachment F) outlining some myths surrounding the Internet Tax Freedom Act on the moratorium of internet taxes. Mr. Brundrett said he wanted to present reasons why he believes the state should enforce the collection of a use tax.

Mr. Brundrett commented on a court case outlined in his handout regarding Furnitureland South and its carrier Royal Transport, which is the largest furniture store in America. Mr. Brundrett said his personal situation is similar because their store loses from \$300,000 to \$500,000 annually to out-of-state businesses, most of them located in North and South Carolina where there are over 200 factory store outlets that are not charging sales tax, creating an unlevel playing field. Mr. Brundrett said he would like the Committee to recommend the enforcement of the collection of use tax. He questioned why Arizona would allow out-of-state businesses an advantage over in-state businesses by not collecting those taxes.

Senator Bundgaard commented that generally when people discuss creating a tax-free-zone on the internet, that they are creating a competitive advantage for remote sellers that could drive companies out of business because of the burden of collecting the tax. He indicated the problem is being pursued regarding the competitive advantage of remote sellers and hopefully some resolution will evolve.

Mr. Brundrett believes that even if the remote sellers were taxed, the growth of internet purchases would still occur because of the convenience or unique product availability. He said his family-owned store will not go out of business because of the internet.

Ms. Ahlmer asked whether Mr. Brundrett had considered putting his business on the internet, and whether he had any discussions with customers about the possible advantages of doing so. Mr. Brundrett replied he intends to have an e-commerce site eventually. However, he said since the internet has emerged, they have discovered that furniture is not a great model to be sold over the internet as far as big-ticket items because customers want the interaction involved in a purchase. He said the problem arises when the customers buy from the retailers, who do not have the same overhead expenses of a physical brick and mortar facility and can afford to sell the merchandise cheaper. Mr. Brundrett said he believes enforcement of the use tax is very achievable,

because of the limited number of businesses in his type of industry that are involved.

Senator Bundgaard asked Mr. Trost to comment on the degree of difficulty in enforcing the collection of the use tax from businesses vs. individuals. Mr. Trost said it is more convenient to go after businesses because they are already auditing their books and records. He said Mr. Aarons commented on that point in his presentation, and that the DOR does not engage in the kind of audit activity involved with people's credit cards or bank accounts to see where they purchased items, whether they bought remotely, or filed a use tax return. .

Representative Hatch-Miller asked Mr. Trost if the collection of use taxes could be collected at the point of sale. Mr. Trost replied that if one has a physical presence in the State of Arizona, there may be a responsibility to collect use tax at the time of sale. He said some retailers in Arizona also have catalog businesses and if purchases are conducted through a catalog, the retailer would have a responsibility at the time of sale to collect on a use tax basis and then remit a use tax return to DOR.

Kay L.Gray, Finance Director, City of Tucson, commented that although the Arizona League of Cities and Towns asked her to make a presentation to the Committee, she was not present to speak on behalf of all cities. However, she said her comments would focus on e-commerce, remote sales and taxation from city to city in Arizona.

Ms. Gray indicated Arizona is unique because it is one of the few states that has an item called the transaction or business privilege tax and although everyone refers to it as a sales tax, it is not. She said a sales tax is levied on the consumer, whereas a business privilege or transaction privilege tax is levied on the business. She stressed that the nexus or relationship of that is very important because in the case of a transaction privilege tax, the tax nexus must be where the business is located, whereas with the sales tax, where the consumer is located. She said that although businesses typically pay the tax and pass it along to the consumer, it is not truly a sales tax, and that is why many areas in Arizona have imposed a use tax.

She said the reason the State of Arizona and cities adopted the transaction privilege tax is because businesses flourish when they have government services, such as street maintenance and police and fire protection. She emphasized that having a public-private partnership in the form of the tax system paying for some of those services makes good sense.

Ms. Gray stated that the City of Tucson levies tax at a two-percent level. It is the single largest source of revenue for the city to fund its general operating budget, which includes police, fire, transportation, social services, parks and recreation, and libraries. She said in the current fiscal year the City anticipates collecting

\$140 million from this revenue source, in addition to the State's shared revenues that they receive from the State's five percent. She said approximately fifty percent of their operating budget is derived from those two sources. She said in the same fiscal year, the \$140 million will pay for \$73 million of police services, \$31 million fire services, and other services.

Ms. Gray said the city is concerned with the growth of internet commerce, therefore, last year their mayor and council requested a study be made of the impact of future sales on the City of Tucson. They commissioned Marshall Vest of the University of Arizona to do that study and they presented their findings last month. The study concluded that in 1988 and 1989, the City of Tucson alone lost about \$3.5 million tax revenues due to remote sales, which included the internet, catalog, television advertising and telephone solicitations and resulted in \$175 million of that figure being lost to local businesses. She said based upon scientific analysis, it is projected that by 2003 the City of Tucson will lose \$30 million in taxes, and local businesses will be impacted by \$1.5 billion.

Ms. Gray remarked it has a significance to the business community and local government and they took it very seriously. She said the internet is a wonderful tool, but the infrastructure still belongs to a community and the revenue source will have to come from somewhere. Businesses and government are intertwined and encouraged in Tucson. Businesses bring high tech jobs and it is important to have the infrastructure available to the citizens to provide education for their children and to retain a funding source for governmental basic services. Ms. Gray said they felt the best way to handle it was through a use tax, because it focuses on where the item is used and not where it is purchased. She said the mechanism is in place to tax the remote sales, for example, large ticket items such as vehicles are brought into Arizona and through the registration process a use tax is often collected. She said that method could be imposed at the time of sale, especially if the company has a physical nexus connected to the state of Arizona. She said the City of Tucson does not have a use tax, but has explored that concept. She questioned how revenues lost to local and state governments will be replaced if there is not a kind of tax replacing those lost revenues, or how will they be able to protect their local businesses with a level playing field. She does not want to see local businesses close their doors, because then the City loses property taxes.

Ms. Gray said they are aware this is a national area of concern and the City of Tucson would like to work with Arizona and other cities and associations to keep the message out there regarding the consequences. She referred to the autonomy of the Model City Tax Code and indicated it is being discussed again this year with the cities and State.

Ms. Gray remarked that the staff of the City of Tucson has been given direction to work with their local technological community, local businesses, economic development areas and all the stakeholders to determine if a use tax is

something to explore or whether to have an alternative. She said the transaction business privilege tax has tremendous impact on the state, cities and businesses and is their "life blood." She would like to see a uniform system of collection with the State and cities sharing or everyone will lose.

Mr. Kelly referred to Ms. Gray's comment regarding revenues lost or foregone and asked what the trends have been for the City of Tucson the past three years since e-commerce has been a topic. Ms. Gray replied the City of Tucson has experienced a growth of approximately five-percent each year in the past three years. She said it is revenue foregone because normally if the business transaction had occurred in the city of Tucson, they would have imposed a tax on it similar to the tax imposed by the State.

Mr. Kelly referred to the Vest Study and wanted to know how they came to the assumption of how many are new transactions vs. a transfer of transactions. Ms. Gray responded that there were some assumptions, but the primary focus is there are things you can only buy out of state or out of town and Tucson does not have a use tax. She said they are also aware that a number of businesses, such as car dealers and large furnishings stores, that complain they do not have a level playing field. She pointed out if a company purchases in Tucson, they will pay a 7% tax, however, if it purchases in another state through remote sales, that company may pay 5% to the state of Arizona for use tax, but they still have a 2% advantage.

Mr. Kelly asked if there were some assumptions on how much of those remote sales at the present time were internet vs. other remote options and how did the Vest Study deal with that in relation to the \$30 million figure. Ms. Gray replied that the majority of the \$30 million represents the internet. She said the \$3.5 million figure is a mixture of the two, but the fastest growing base is the internet and not catalog, television or telephone sales. She said the reason the City requested a study be done is because of the potential growth of the internet. Ms. Gray indicated she would be happy to forward a copy of the Vest Study to the Committee for its review.

David Deans, with U.S. West and also founder and Sales Manager, Economic TeleDevelopment Forum, commented that several months ago, the Arizona League of Cities held a seminar on the subject of economic development as it related to E-commerce. He said he was disappointed at the overall tone because information provided related to the downside of the impact of e-commerce on retail sales taxes, and there did not seem to be any information regarding potential upside that could occur in a community. He said he was concerned that without a balanced perspective, the upside potential will not be known unless research is conducted. He cited the telecommunications services taxation as an example and indicated that municipalities and states can find sources of other tax revenue if they invest the time to research. He pointed out that eight states currently do not tax telecommunications services at either the

state or municipal level and none of those states has suffered a negative impact, so they must be getting their tax revenues from other places.

Mr. Deans remarked at that seminar a question was posed by a council member from Sierra Vista, who suggested that perhaps local public entities need to be more flexible about where the revenues are derived. Mr. Deans said he believes it deserves more thought as an investment on the upside potential of the internet that would balance the downside.

Ann Dumenil, representing herself, commented she is an Attorney with Jennings, Strouss & Salmon, and a Certified Tax Specialist and has twenty years experience with state and local taxes. She said she also serves on a variety of business committees throughout the state and recently encountered problems with city sales taxes on internet services that she wanted to relate to the Committee. She pointed out that in 47 states there is one state sales tax, one set of rules and one set of interpretations. Arizona not only has a state sales tax, but all the cities have their own local sales tax with different laws, regulations and interpretations including local variances with the cities, therefore, the problem with city sales taxes are magnified in Arizona. She said there are two new areas of taxing internet services that businesses have recently encountered. The Arizona cities are trying to tax internet access fees under its city tax classification for telecommunications. She said DOR has issued a tax ruling that the internet access fees are interstate telecommunications and are not in-state in nature and, therefore, the State of Arizona is not imposing a State sales tax on internet access fees. The Model City Tax Code also provides that the cities cannot tax interstate communications, however, a number of cities are trying to impose a local city sales tax on internet access fees. Ms. Dumenil believes a number of businesses view this new city sales tax on internet access fees as being a direct violation of the federal moratorium on new taxes on the internet, and if they are correct, it violates the spirit of the moratorium.

Ms. Dumenil commented that a second area where taxes are being imposed on internet services relates to internet web site design, development services and web site hosting services. She is aware the City of Chandler is currently attempting to impose a city sales tax under its local advertising classification on an internet company that does web site hosting services and develops web pages. She said that in the mid-1980s, Arizona repealed its tax on local advertising and many of the cities retained that local advertising tax, which is the sales tax related to billboard, local radio or local television advertising. She indicated a serious problem exists in putting a web page on the World Wide Web in relation to local advertising. Companies are being audited and assessed city sales taxes on their entire revenues including web site development services under the notion that it is local advertising. The result is having a devastating impact on a few local businesses that have been audited, and many are considering moving their internet business out of Arizona because of the city's attempt to tax internet services. Ms. Dumenil believes this taxing violates the

federal moratorium against new taxes on the internet, and when cities impose new taxes on the internet without considering all of the economic development consequences, it may have an adverse impact on internet companies locating in Arizona. She said if an internet company can locate in California, Texas, or Utah and not have to face the local sales taxes on some of the advertising services, they have a strong economic incentive to locate outside of Arizona.

Ms. Dumenil said there is concern that the cities may find other new types of internet services to tax. She urged the Committee to consider some recommendation to impose some form of moratorium prohibiting any form of new city sales tax or city use tax on internet access fees, internet web site design and development services or web site hosting services. She said at a minimum she feels the Committee should consider a statewide policy that would impose a moratorium prohibiting the Arizona cities and towns from imposing some local city sales or use tax on activities that are not taxed by the State of Arizona.

Senator Cunningham asked if there are cities currently taxing a web site design, and would there be any difference between that and the design for an ad in the yellow pages. Ms. Dumenil replied the city sales tax on local advertising would not be applied to design services that someone would normally perform for a national or local ad. She said the problem arises when the city wants to tax all activities including the web hosting service and web design service because they feel it constitutes local advertising. In addition, the cities are seeking retroactive taxes including penalties and interest. As far as those businesses currently undergoing audits, it has not been determined that designing web pages is local advertising, so the costs have not been segregated between taxable and non-taxable.

Representative Hatch-Miller remarked that two weeks ago Senator John McCain sent the Committee a letter indicating he relied heavily on information provided to him in a report compiled by Ernst and Young, therefore, Jim Eads, Partner with Ernst & Young, was present to brief the Committee on their findings.

James R. Eads, Jr., Partner with Ernst & Young LLP, Atlanta, distributed copies of his presentation (Attachment G) and commented that e-commerce is a big deal in all aspects of what it has done to business, creating enormous capital and making instant millionaires out of young entrepreneurs as well as traditional business people and those who never expected to have a career in business. He said e-commerce has also caused chief executive officers to gain and lose jobs. He presented numbers on the growth of the internet stating it took four years to register the first million domain names on the internet and three months to move from four million to five million domain names. He noted through August of 1999, 154 Initial Public Offerings (IPO) have raised \$13 billion in capital and 230 IPOs are in registration. He said despite these phenomenal growth figures, Forrester Research, a company that studies the internet, indicated that e-

commerce will only represent about six percent of all commerce over the next few years.

Mr. Eads said earlier this year Ernst & Young published a study entitled "The Sky is Not Falling." He noted the major finding was although governments discussed lost revenues as a result of e-commerce, those losses were not significant when compared with total revenues. He said in 1998, the total revenues lost to governments as a result of e-commerce nationally was \$170 million. Mr. Eads reported that no state including Arizona makes any effort to collect use tax from individual purchasers, but all states including Arizona do make an effort to collect use taxes from businesses that are purchasers. He indicated the IRS is auditing those businesses as a routine, so they make sure the use tax is collected.

Mr. Eads stated that the findings in their study have been confirmed. He referred to an article in States Tax Notes regarding a report by Richard Hawkins of the University of Florida who studied the impact of e-commerce on the State of Florida. Mr. Hawkins pointed out that the sales tax crisis is not an internet crisis, but centers on the fact that one cannot trust the archaic structure of typical sales taxes in this changing economy. Mr. Eads said the Florida study corroborated the Ernst & Young study, which indicated e-commerce revenue losses are simply not significant at this point.

Mr. Eads noted that Dr. Austan Goolsbee, an economist at the University of Chicago, testified at the Advisory Commission conference that consumer purchases over the internet would decline as much as thirty percent if taxes were introduced as a normal part of that business. He said that BizRate.com, an internet observing organization, issued a press release in July 1999 indicating only thirty-seven percent of buyers would make online purchases if they were taxed. Mr. Eads said consumers are simply not accustomed to being taxed for internet purchases and view it as an intrusion.

Mr. Eads pointed out the application of the internet tax is complex and the question becomes who should bear that cost. He obtained statistics showing the various units of government in the United States: there are 84,955 units of local government in the U.S., 3,000 counties, over 19,000 municipalities, 16,000 townships, 14,000 school districts, and 31,000 special districts. Mr. Eads noted that AT&T files 39,912 state and local tax reports in the course of a year, which calculates to a tax report being filed every 3.12 minutes.

Mr. Eads said the debate is not about the need of government at any level to fund essential government services. He quoted Mayor Ron Kirk of Dallas, a member of the Advisory Commission on E-commerce, who noted "while you are surfing the net and making purchases and not paying any tax on it, if you smell smoke and turn around and see fire, and you dial 911, do you want your city to send you a virtual fire truck to help you or a big red real fire truck?" Mr. Eads said obviously governments need revenue sources to provide these essential

services, but who should bear the cost of getting that money into the revenue stream for government.

Mr. Eads noted the 1992 decision of the Supreme Court in *Quill Corp vs. North Dakota*, which affirmed an earlier decision by the Supreme Court in another case in 1967. He commented the issue of taxation of remote sales has been around for over thirty years with no solution, and today the internet has caused policymakers to think about the issue. He said the *Quill* decision is based upon the Commerce Clause of the Constitution of the United States, and some governments are suggesting that Congress should now do something about it, but the question becomes at what cost.

Mr. Eads remarked he appreciated the perspective of the local furniture store owner, and believes the owner has an unfair competitive advantage with the sellers in North Carolina who are not collecting any tax when they sell to purchasers in Arizona. Mr. Eads noted many young entrepreneurs have become very successful due to remote internet sales. He said Ernst & Young did another study addressing that issue, which indicated a new entrepreneur entering business who might have to immediately comply with thousands of tax rules could incur costs up to 87 percent of every \$100 of taxes collected and sent to Arizona.

Mr. Eads commented that the key policy implication of the study is that fundamental changes are needed in the sales and use tax system to simplify the system. He said state and local governments must not become masters of complexity, but masters of simplification to reduce the burdens currently borne by multi-state sellers.

Mr. Eads cited a number of court decisions over the past few years in his written presentation regarding nexus, however, he noted none of them deal with tax nexus because there has not yet been a case dealing with that issue. He said most of the cases have held that simply having a page on the World Wide Web does not create sufficient nexus to be brought into court. He cited the case of *Cybersell, Inc., an Arizona corporation, vs. Cybersell, Inc., a Florida corporation*, where the Florida corporation had its web page installed, and the Arizona corporation sued the Florida corporation for trademark infringement. The Ninth Circuit Court of Appeals ruled that simply having the web page visible in Arizona was not sufficient alone to invoke Arizona law against the Florida corporation.

Mr. Eads noted the Internet Tax Freedom Act accomplished three goals: (1) it placed a moratorium of new taxes on internet access; (2) it prohibited discriminatory taxation of e-commerce; and (3) it created the Advisory Commission on Electronic Commerce. He said debate and consideration of these issues has been discussed before the Commission in its first two meetings. Mr. Eads testified before the Advisory Commission in its New York meeting and prior to that meeting, the Advisory Commission received a letter from several

members of the United States House of Representatives expressing their opposition to new taxes on the internet and suggesting that the Advisory Commission concentrate on international tax issues, however, thus far it has not done so. Mr. Eads noted the day before the Commission's meeting in New York, an organization known as the Global Business Dialogue on Electronic Commerce met in Paris and issued a briefing paper stating that e-commerce will have fundamental implications for taxation and pointed out there is a need for clear, simple and predictable tax environment for electronic commerce.

Mr. Eads said the Advisory Commission on its web site has asked for suggestions or a proposal regarding how a tax system might be designed that would facilitate the collection of tax on e-commerce, if such a decision was made. Guidelines have been established for these proposals, which are expected to be reviewed at their meeting in December in San Francisco as follows:

1. Simplification: How would the proposal fundamentally simplify the existing system of sales taxation.
2. Taxation: Does the proposal impose any taxes on internet access or new taxes on internet sales.
3. Burden on Sellers: Does the proposal remove the financial, logistical and administrative compliance from sellers.
4. Discrimination: Does it treat purchasers of like products or services in as like a manner as possible.
5. International: Does it affect United States global competitiveness.
6. Technology: It is technologically feasible using widely available software.
7. Privacy: Does it protect the privacy of consumers.
8. Sovereignty/Local Government Autonomy: Does it respect the sovereignty of states and Native Americans.
9. Constitutional: Is it constitutional.

Mr. Eads commented he believes these are admirable goals, but as he views it, if one cannot ask the seller nor the buyer, and one wants to respect sovereignty without any new taxes, it is not certain how the money can be collected. He noted three bills are pending in Congress dealing with this issue. Senator McCain has introduced SB1611, which would make the moratorium enacted in the Internet Tax Freedom Act permanent and ban state and local taxes on sales of goods over the internet. Senator Hollings of North Carolina introduced SB1433, which would impose a federal excise tax on all goods sold in interstate commerce that were not otherwise subjected to state and local taxation in order to supplement state and local funding for teachers' salaries. Senator Smith from New Hampshire introduced SB328, which would make the Internet Tax Freedom Act moratorium permanent.

Mr. Eads said in addition to the Ernst & Young studies provided to the Committee, he suggested logging on to the National Tax Association web site,

NTAnet.org. He said over the past two years a group consisting of forty-seven individuals from businesses, government and academia met and attempted to discuss the issues. He said the good news is the group produced a fine report that explores the issues, however, the bad news is they were not able to arrive at a solution because no one could agree.

Mr. Eads remarked the bottom line is businesses want a simpler system. He suggested that this is a critical economic juncture in our nation's history, and it may be time to look at a different simpler kind of tax system rather than overlaying an old one onto a new form of commerce.

Representative Hatch-Miller noted Ernst & Young is an e-business consulting firm among other things with \$620 million worth of e-business activity according to its web site. He asked Mr. Eads to comment. Mr. Eads replied those are businesses that seek the advice of Ernst & Young in setting up their e-commerce businesses. Representative Hatch-Miller asked whether Ernst & Young has a system to maintain those revenue streams. Mr. Eads responded they do not, and believes that state and local governments and businesses currently have the best opportunities to reach any sort of agreement with regard to this taxing issue. He commented that it is about money and the power of government to force collection to fund services, and the issue is at what cost and to whom. Mr. Eads believes if government will take a leadership role towards a much simpler scheme of taxation, it will derive support from a significant part of the business community to resolve the issues. He said although there is some disagreement, this is the first time in over twenty-five years that he has witnessed meaningful dialogue about this issue and a possibility of resolution.

Mr. Kelly referred to a report Mr. Eads issued regarding the notation that eighty percent of e-commerce is business-to-business and not subject to sales, use or other taxes. Mr. Kelly asked whether there is a net revenue analysis of e-commerce on business-to-business, and whether that is causing a decrease or increase in revenues to the various taxing jurisdictions.

Mr. Eads responded that Mr. Kelly's question was outside the scope of that particular study, however, he commented he heard that e-commerce is drawing most heavily from other forms of remote commerce. He pointed out that in some instances customers want to interact with the product at the local business store to make that purchase. He said if someone is willing to pick up the telephone and order a shirt from a store in Maine, the same customer will probably order that same shirt over the internet. So he believes it is plausible to argue that e-commerce is making its heaviest inroads into other forms of remote commerce and not main-stream commerce.

Mr. Kelly asked Mr. Eads whether there is any analysis of the net revenue impact of new equipment and capital investment on any of the taxing jurisdictions because it appears there are other revenue flows in addition to transaction tax

issues. Mr. Eads replied that the businessperson mentioned in a recent local news story, who started out with \$2,000 in loans from his credit card company and built a \$1.4 billion dollar business, generated major tax revenues. That business's employees paid taxes, they bought items locally and paid additional taxes. Mr. Eads said although he is not aware of any analytical statistics, it would appear that the general economic activity surrounding e-commerce generates tax revenues.

Representative Hatch-Miller thanked everyone for their participation and announced the sub-committees will be meeting as soon as schedules are coordinated. He said a work group meeting will be held the following week in the basement of the House of Representatives, Rooms 38 and 49, and suggested everyone submit their ideas which will later be formulated into a report. He announced everyone would be notified by email, and that the next full Committee meeting would be held in two weeks.

There being no further business, the meeting adjourned at 4:36.

Respectfully submitted,


Nancy L. DeMichele
Committee Secretary

(Tapes and attachments are on file in the Secretary of the Senate's Office)

MEETING OF COMMITTEE ON
INTERNET STUDY

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DEC 14 1999

ARIZONA STATE LEGISLATURE **SEC OFC.**

STUDY COMMITTEE ON INTERNET PRIVACY, JURISDICTION
REGULATION AND TAXATION

Minutes of the Meeting
November 17, 1999 – 2:30 p.m.
Senate Appropriations Room 109

Members Present:

Representative Jeff Hatch-Miller, Co-chair	Representative Barbara Leff
Senator Harry E. Mitchell	Representative Debora Norris
Senator George Cunningham	Representative Ramon Valadez
Dr. William E. Lewis	Representative Barry Wong
The Honorable Chris Bavasi	Michael McNulty

Members Absent:

Senator Scott Bundgaard, Co-chair
Senator Ken Bennett
Senator Marc Spitzer
John Kelly
Peter Charlton
Michelle Ahlmer

Staff:

Jeff Kros, Senate Finance Analyst
Tami Stowe, House Majority Research Analyst, CM, Gov. Ops.

Representative Hatch-Miller called the meeting of the Study Committee on Internet Privacy, Jurisdiction, Regulation and Taxation to order at 2:30 p.m. Attendance was noted. See attached list for other attendees (Attachment A).

OPENING REMARKS

Representative Hatch-Miller announced that today we are going to discuss two issues: taxation and privacy. He said a subcommittee meeting on taxation was held earlier and members arrived at a consensus about basic principles that should be considered by the Governor and Legislature when discussing legislation. He commented that he would like to share some of his own thoughts on taxation of Internet sales with his Power Point presentation, and welcomed the Committee's comments.

Representative Hatch-Miller gave a Power Point presentation and commented on the frustration he experienced when attempting to pay a tax on a purchase he made over the Internet. He said he called the City, County and State and finally obtained the necessary information. He remarked he has been trying to understand and assemble the arguments against taxation, and it does not make sense. He pointed out some arguments against taxation of purchases over the Internet as follows:

- There are too many tax jurisdictions and it is too complex.
- Compliance would be a hardship on e-businesses, completing all the forms, computing the tax, along with the collection and record-keeping process.
- It is a Constitutional issue, because interstate commerce cannot be taxed.
- If a tax were imposed, people would avoid paying it.

He said e-commerce growth is phenomenal and that Internet development should not be discouraged.

Senator Cunningham asked if products were taxed on the Internet whether that would create a price disincentive and result in a decrease of usage. Representative Hatch-Miller replied he believed some people would be less likely to make a purchase because of additional cost and shipping, but other factors are involved and individuals shop on the Internet because:

- It is a novelty.
- It is interesting and convenient.
- There is a wider selection of products, which are sometimes less costly.
- There is extensive available information.

Senator Cunningham asked whether people shopped on the Internet to avoid paying sales tax. Representative Hatch-Miller replied he believes that is possible, but there are other reasons people shop on the Internet as mentioned earlier. Representative Hatch-Miller commented that new software is being developed which will be able to compute the tax as easily as credit card purchases. The software allows the transaction to be made directly with the purchaser before the money goes to the seller, so the seller is not involved.

Representative Hatch-Miller said Internet taxes are thought of as a means historically, where local communities assess a fee on sales to pay for local police, fire, and other public necessities, therefore, it is considered a local activity even though the product may be purchased from out of state. He said if the buyer resides in Arizona and not the seller, it will not be going over state lines and instead be based upon state and local use tax laws. He said the use tax is not based on the sale, but rather on an activity of the use of the product in the State. He said the only store that exists is a visual image on the monitor of the user's computer. The most logical point of sale is a residence or business address of the purchaser and local taxes at that address would apply.

He commented another argument is that the tax law cannot be enforced. He said if the tax is deducted from the payment at the time of processing rather than by a seller, then it is not a transaction privilege tax, there is no collection and it just remains in Arizona. He said even with the existing tax laws, there are those people who will try to circumvent them. He said as long as there is education, consistency and enforcement, the public will be required to pay the use taxes.

Representative Hatch-Miller outlined the model system proposed by the Republican Governor of Utah. He pointed out that the buyer sees the product and requests purchase information from the seller. The buyer then electronically contacts the funds transfer processor and indicates he wants to buy the product and the processor computes the tax based upon the zip code of the buyer. Assuming a purchase is made, the processor allocates the total sales price including cost, tax, and shipping. The processor then distributes that information to the proper entities and minimal information is required of the buyer and seller. The seller then arranges to ship the product and the funds are distributed electronically at the same time. He said another argument is e-sales tax revenue. He said the other side of the argument is that it only shifts the point of purchase and the same dollar amount is achieved.

He pointed out there are groups forming regarding the underlying taxation debate as follows:

- A group that does not like government expansion and does not wish to go into the new Internet area.
- A group of business people who feel it is in their best economic interest to have a tax-free zone on the Internet.
- A group who does not like sales taxes.
- A group who would rather have a national sales tax.

He said those four groups are interested in keeping the Internet a tax-free zone versus the providers of local services, such as police, fire, libraries, etc., and businesses that would like a level playing field and equal treatment under the tax laws.

He indicated some people are using the National Tax Freedom Act as leverage for decision-making, and that legislation is being introduced in Washington to collect the tax. He outlined the tax principles:

- They need to be fair, simple and limited.
- They should apply equally to all transactions.
- Technology should be easy to implement for businesses and buyers to use.
- Limited sales should be taxed but not the use of the Internet itself.
- Citizens should not be penalized for choosing to do business with the local retail establishment.

He said another alternative suggestion is if there is a tax-free zone, perhaps there could be a pre-tax assessed on the first \$100 of sales, whether from a bricks and mortar business, catalog or Internet. Small businesses could be given an advantage because it is difficult for them to compete, and perhaps it would bring new entrepreneurs to the Internet. Representative Hatch-Miller said he believes a method for collecting e-sales tax is technically achievable and that it is merely a matter of writing the program and negotiating. He said there is prior court precedence, political debate and other factors to discuss.

Sen. Cunningham commended Representative Hatch-Miller for the excellent presentation.

PUBLIC TESTIMONY

Stephen Ellis, Director of Security and Privacy Policy, Intel Corporation, commented his presentation would center around the privacy issue with an update of United States industry and Intel's position on the issue. He also planned to discuss European consumer attitudes and privacy and the direction in terms of the Federal Communications Commission (FCC) regulations and future outlook.

Mr. Ellis said in terms of the United States industry update, it generally has been positive and there has been awareness and education conducted as a group. He said most national companies are members of an on-line privacy alliance, and the members have set up guidelines in terms of how they conduct business electronically. A number of companies have introduced changes in their advertising policy and do not advertise on Internet web sites that do not post a privacy policy statement along with full disclosure to their customers or potential customers as to how personal identifiable information is handled. He said that contracts between companies and subcontractors are including verbage in the contracts relating to third-party data and the protection provided.

Mr. Ellis indicated there are industry alliances forming to develop privacy-enhancing technologies as well. One alliance includes Intel, Microsoft, Compaq, Hewlett Packard and IBM, known as the Trusted Computer Platform Alliance (TCPA), which is defining enhancements for the PC platform to make it more secure and also provide a foundation for enhanced user privacy. A second group was founded by a number of large companies known as the International Security Trust and Privacy Alliance (ISTPA), which from a technological perspective determines what technologies can be run on top of the platforms. One of the technologies is the P3P or Platform for Privacy Preferences, which is a way to automate a web browser that sets up a profile to define what an individual wants to divulge. The site would either do it automatically or the individual would be warned if the site could not satisfy those particular preferences.

He commented on the Safe Harbor negotiations with the European Union (EU) and indicated it is a positive step forward.

He said Intel introduced the processor serial number feature in January 1999 in its Pentium-3 processor. He said the companies that build personal computers had requested it as a manufacturing feature and the idea was to allow them to further automate their manufacturing process. He said a number of independent software vendors also expressed interest in being able to use the feature in their applications.

TAPE 1 – SIDE B

Mr. Ellis remarked that since the processor is used in both consumer and business applications, Intel provided a windows-based control utility that presented a user-friendly interface to control the feature. He said there was initial reaction from both privacy and security communities because of misrepresentation that the feature was beaming one's identity over the Internet, which was not true. He said the feature only works if the user allows software to run on his machine and only if the feature itself is enabled. However, some groups were still concerned over consumer-user control and web abuse of being able to cross correlate information and build data bases to develop profiles on certain customers based on where they had visited on the web. The feature that Intel's customers found most useful was in business uses, such as network management and asset management. Mr. Ellis pointed out since that time Intel has worked with a number of the advocacy groups and the experts to get a better understanding of their concerns. He said as Intel looks into the future to new products, they look for feedback in advance in order to implement the technology in a more private user-friendly way

Mr. Ellis indicated Intel has dedicated new resources and developed a set of privacy guidelines for web developers. He said privacy training with business

units is also being conducted regarding sensitivity in terms of product development, and there is an internal task force that reviews products and services in the developmental stages.

Mr. Ellis discussed external actions Intel has taken. He said that in addition to the privacy policy posted on the Intel web site, they also post a set of privacy principles, which outlines how Intel discloses information to any potential third parties and that information is available for consumers.

He said Jupiter Communications, a marketing research company, recently did surveys on European consumer attitudes, which indicated that Europeans have a more developed body of privacy law than in this country, but the consumer attitudes are the same. He said only ten percent actually have a privacy policy on a home page or a link that is available. Mr. Ellis said European consumers are just as willing as consumers in this country to potentially trade their personal information for what they consider to be value. However, surveys indicated that security is still a barrier to buying on line and in Europe sixty percent of consumers are reluctant to put credit card information on the Internet. In this country consumers enjoy a \$50 limit of any misuse of the card, whereas in Europe the consumer is responsible for all charges on the card. He pointed out that educating the consumer, being up-front with full disclosure and communicating with customers are good business practices worldwide.

He said the Federal Trade Commission's (FTC) approach with respect to Internet privacy focuses on three special populations: children, the health care industry to ensure medical information is protected, and financial and banking industry transactions.

Mr. Ellis commented on the future outlook. He said there were fifty bills introduced this session at the federal level pertaining to privacy. The most significant was the bill that requires the FTC to draft legislation requiring companies to protect an individual's privacy, provide notification of any data collection, and provide for the consumer to allow or not allow disclosure. The bill will allow consumers to be able to access any stored information and update or correct that information requiring companies to maintain the data securely. It will also allow states to enforce regulations against offenders. He said at this point there has been no action on any of these bills, but he thinks there will next year, and because of the various jurisdictions that Congress is the appropriate forum to address this issue.

He commented the financial modernization bill now gives states the ability to adopt rules on the privacy of consumer financial records. He said because of the many different jurisdictions, consistency will be important to businesses in terms of their ability to manage it properly.

Mr. Ellis summarized his presentation by stating that Intel and the industry are committed to handling these critical issues in the right manner. He said as an international company, Intel has to protect its customers around the world. He indicated they have focused on building the internal habits and some tools to build products to be compliant with their principles and are committed to making self-regulation work.

Representative Wong referred to Mr. Ellis' remark regarding alliance of the various companies trying to develop some type of policy and self-regulation on privacy matters and asked whether it applies to e-commerce privacy. Mr. Ellis replied that it applies to all aspects of Internet communications with customers including on-line commerce and any type of electronically-based communication.

Representative Wong said it is his understanding that it is an attempt by the industry to self-regulate in order to avoid something more onerous from the government. Mr. Ellis responded he feels the industry can move quickly and that self-regulation provides the fastest means for re-acting. He said when customers speak with respect to Intel's products, they re-act very quickly. He indicated most companies value their relationship with customers and want to do what is right.

Representative Wong commented he applauds the industry in taking a pro-active approach because he prefers that industries self-regulate. He said his major concern is when the consumers do not know the information is being harvested for marketing reasons and asked whether consumers are aware that they have a right to disable harvesting information. Mr. Ellis replied that the P3P technology has some of that capability built in, which includes a user interface and visual icons. He said as a part of self-regulation, if there is any information being collected, customers can opt-out of having that information collected.

Representative Wong referred to the "slamming" technique in the telecommunications industry, and said he wants to be sure there is a clear notice to the consumer in a certain obvious size print that they understand the implications, if they do not use the disabling device. Mr. Ellis agreed.

Chris Fagan, Practice Manager for Microsoft Consulting in the Southwest District headquartered in Phoenix, commented he has been with Microsoft in Phoenix for the past year and previously with Microsoft in Australia. He remarked that privacy is a major issue with their customers and said his presentation would focus on the status of the industry here as well as overseas and how Microsoft fits into that picture.

Mr. Fagan said Microsoft's goal is to build the Internet as an official medium for global communications and one that is trusted among consumers. He said they participate in three ways:

1. As a software developer.
2. As a large member of the industry they are very interested in participation with Intel, IBM, Netscape and other companies to move the whole industry forward. Self-regulation is important and Microsoft is good in replying rapidly to industry changes.
3. As a content provider on the Internet, they are interested in ensuring that it is safe, trusted and respected.

Mr. Fagan commented that Microsoft has been involved in privacy issues since the early days of Disk Operating System (DOS). He said the Platform for Privacy Preferences (P3P) is a software standard that was developed by the World Wide Web Committee and is the standard-setting body by which companies will develop software.

He said in June 1998 the Internet Privacy Alliance, which includes over fifty companies, was formed and is committed to protecting the privacy of individuals. He explained there is a non-profit organization called "Trustee," that has formulated a set of very strict standards and a logo that can be displayed on web sites, which also has a third-party audit mechanism to ensure those guidelines are being followed.

Mr. Fagan said one of the problems with privacy policies is there are many of them on the Internet with different standards and not necessarily the quality that some of the more senior members of the industry would like to see. Microsoft has made a number of moves to raise those standards including providing a "privacy policy wizard" for people who develop web sites. The "wizard" helps to develop a privacy policy standard required by organizations such as P3P and Online Privacy Alliance. It has helped to raise the standard within the industry and Microsoft will only advertise on sites that support that type of standard.

Mr. Fagan commented on Microsoft's privacy policy, which is based on the principles of disclosure and informed content. He said when an individual clicks on to a Microsoft web site, there is a link to the private policy on the bottom of the first page. The comprehensive notice outlines how provided information would be gathered and includes a consent form to use that information for other purposes. (Attachment B).

Mr. Fagan indicated another point is access. He said that Microsoft developed a tool called "Microsoft Passport," which enables consumers to be able to edit their information on line as it is gathered by the site as long as the standards are met.

TAPE 2, SIDE A

Mr. Fagan summarized by stating that Microsoft is very concerned about the privacy standards on the Internet and participates from the three elements of their business that will help move the industry in a sensible and mature fashion.

Representative Hatch-Miller referred to Microsoft's operating system software as being the core of the industry and asked whether the concerns from the public about privacy will be well addressed, particularly regarding the fear of disclosures. Mr. Fagan replied as the use of information becomes more sophisticated, the industry is continually educating and setting standards to alleviate those fears.

Representative Hatch-Miller asked about the extent of information that is collected by Microsoft from users who sign up on their site. Mr. Fagan responded that information is collected on Microsoft's site of those who sign up for particular purposes, but not specifically about individuals who use the sites. He said, for example, if an individual wishes to register for a product or service, Microsoft processes a number of e-mails informing users of products and upgrades. He said if a user registers for information through various Microsoft sites, there is an opportunity for that information to be collated and it assists Microsoft in upgrading product information for the user.

Representative Hatch-Miller asked whether Microsoft sells user names and addresses. Mr. Fagan replied the selling of data is not Microsoft's intention, but the data is organized to provide a personalized service to the individual. He said there are advantages for individuals who wish to register for information and from Microsoft's point of view, they wish to help individuals use their tools and products well.

Representative Hatch-Miller asked whether Microsoft is able to easily identify and track a user who sends harassing e-mail. Mr. Fagan apologized for not being able to respond specifically to that question.

Dr. Lewis responded that a user always has some form of identification, but hacking is a problem. He said, for example, a user can make it appear that the e-mail is coming from someone else, which then becomes difficult to track, although there are ways to do so.

Gladys Ann Wells, Director, Department of Library, Archives and Public Records, commented she has worked with colleagues in other state library agencies as well as followed various legislations, and believes the Committee's work is critically important.

She commented that her organization is responsible in Arizona for ensuring public access to information, maintaining the continuity of research along with universities, ensuring that public records remain in perpetuity and that Arizona's history remains a part of the public domain. She pointed out the importance of research and that the information must be current, reliable, replicable, clearly documented and verified. She said some people have inferred that libraries are not needed any more because of the Internet. She remarked that although she agrees the Internet is an incredibly new tool, it also carries certain liabilities and the ability for anyone to post information on the Internet is one of those liabilities.

She said another problem is the factor of longevity and on-going perpetual research. She indicated they provide an Internet site and also assist libraries with public records and archives of Arizona, but if information is removed from the Internet there is a problem in protecting the research that has been accomplished.

Ms. Wells said the universities are challenged in many ways. At a recent meeting she attended sponsored by Arizona State University for records managers, it became clear that raw material for scholarship and litigation is being lost at an alarming rate. She said archivists and records managers find themselves "in a brave new world in which institutions do not know what digital records should be kept, for how long, for whom, who should have access to them, and how they should be migrated." She emphasized in everyone's attempt to use this wonderful new tool, the regard for individual inquiry and the privacy it requires may be lacking.

Ms. Wells commented there is also a concern for permanent public access, which is a major issue both at the federal and state level. She said another concern is the Internet filtering issue, especially as it relates to children. She shared a story and an incident that took place because of an Internet search, which occurred recently at a Phoenix library. However, she said that was only one isolated incident and compared that to the over nineteen million individual visits to libraries this past year, and stressed the safety of being in a library. However, they realize it is an issue and have asked librarians across the state to work with them on Internet policies. In addition, communities across the state have met to discuss how this type of incident impacts those areas. She said she does not believe filters work and at best are a "stop-gap" screening out some negative content. She indicated she spoke to Senator McCain, who is sponsoring legislation. She said he changed part of his legislation to ensure that computers requiring filters would apply to those totally used by children. Ms. Wells expressed appreciation to the Gates Library Foundation (Microsoft) for the \$3 million of new computers to be installed in libraries in Arizona within the next two years.

Representative Hatch-Miller said he was disturbed to hear that software does not work the way it should. Ms. Wells replied she meant from a research point of view, but believes as technology evolves, it may improve. She said libraries are about communities. She added that at least twenty percent of material in a library is unique to a particular community, and it needs to remain that way because a library belongs to a community as a part of its history. She said filters get in the way because it takes the decision for what materials should be in a library out of the community's hands. She said she shares everyone's concern, but believes more needs to be done about safe and decent sites and communities need to stay involved.

Christine Aguileia, Executive Vice President and General Counsel, Skymall, Inc., commented that Skymall is a Phoenix-based company and largest in-flight catalog company in the country, and their catalogs are available on seventy percent of domestic airlines. She said they also have a web site where merchandise is sold to consumers. She said her presentation would include an industry overview and privacy policies.

Ms. Aguileia pointed out that the direct marketing industry has been around for many years, referring to the whole catalog retailing industry of which Sears Roebuck was the pioneer in the 1950's and 1960's. She said as shipping improved in the 1970's and 1980's, the catalog industry thrived and currently it is a hundred billion dollar industry that is comprised of 12,000 different companies. She said for over thirty years the industry has dealt with privacy issues. She remarked the foundation of the direct marketing industry is to gather customer data and to use that data to make targeted offers to consumers as well as to share it with other participants in the industry.

She said the businesses involved in the catalog industry have developed systems and methodologies for appropriately sharing data with each other. She commented that although it may appear as being counter-productive to share data, the industry demonstrated that value in the data was increased when it was shared because it encouraged consumers to shop from a direct catalog as opposed to driving to the mall. She said the tests performed indicated the more the data was shared and used, the more it changed behaviors and made remote shopping a favorable way for consumers to conduct business.

TAPE 2, SIDE B

Ms. Aguileia remarked there are few laws that regulate privacy, specifically those laws that target children, banking, and other areas of importance. She said she believes there has not been a lot of regulation, particularly with direct marketing because individuals have voluntarily adopted policies and self-regulation. She said reputable direct marketers prevalently post their privacy policies, explaining to the consumer what data is being collected and how it will be used. She said

there are organizations that will assist in formulating policies and the proper way to appropriately use consumer data.

Ms. Aguilera explained that most privacy policies are referred to as opt-out policies, which is set up whereby the consumer has to specifically request not to be sent any other marketing materials as a result of sharing their information with the company that is taking the data. She said although Sky Mall and other companies have opt-out policies, there are very few consumers who opt-out because most consumers who place an order with a company find it valuable to then get further offers from those who have similar product offerings. She said the fact that people can opt-out, and most of them choose not to, is a significant fact to think about in terms of additional legislation.

She said opt-in policies are less common and are more prevalent in situations when more data is revealed. She pointed out one such site is Mypoints.com, where depending on the data voluntarily provided, targeted offers will be sent based on an individual's interests, hobbies and demographic profile.

Ms. Aguilera commented on Sky-Mall's perspective with regard to trends and privacy policies. She said technology improves every day and they are able to offer consumers better targeted marketing materials and offers, and most consumers appreciate having those features and are less bothered by the mail they get that is unsolicited. She said Sky-Mall has a diverse product base and has found that consumers are appreciative and consider it non-intrusive if an item is ordered and information is sent regarding another item that might be of interest based on Sky Mall's analysis of its data base.

Ms. Aguilera emphasized that the growth of the direct marketing industry has flourished not because people were careless about the consumer data. She said most companies are scrupulous in how they gather and use that data and market forces will weed out companies who are abusive and misuse customer data in an inappropriate way. She said The Direct Marketing Association, which is one of the largest trade organizations in the country, has programs and services for consumers who want to eliminate unsolicited mail. All one needs to do is write to the Association and they will remove an individual's name from any mail list in the country and also eliminate a telephone number from the telephone banks.

Ms. Aguilera summarized by stating that the direct marketing industry, which has been around long before the Internet, has been a model for gathering and using customer data in an appropriate way and has survived under a self-regulation model. She said she believes that model is appropriate for the Internet and would not require any further legislation in general to address privacy concerns.

Representative Wong asked Ms. Aguilera to comment on Sky Mall's position on taxation relative to e-commerce and catalog sales. Ms. Aguilera replied that Sky

Mall has historically collected and remitted sales taxes in all jurisdictions that have a sales tax, which amounted to approximately 50,000 different taxing authorities. She said software programs are available, but it has been a difficult and expensive process and exposed the company in certain circumstances that was unfortunate and regrettable.

Ms. Aguileia remarked that Sky Mall believes the Internet is a great opportunity in our history for a new industry to grow and thrive, however, taxing the Internet at this point is not something that will be conducive to facilitating that growth. She indicated that retail sales are a three trillion dollar market and the amount of Internet sales in the next projected period are just a small fraction of that total. She believes Internet companies should be allowed to compete and get established and at some future point maybe it will be appropriate to consider taxing, but not at this time.

Eleanor Eisenberg, Executive Director of the Arizona Civil Liberties Union (ACLU), commented there is an explosion in information technology, which presents both opportunities and challenges. She said courts and legislators across the country are grappling with a number of significant issues raised by new technologies including search and seizure issues, which generally are not thought about with respect to Internet privacy.

Ms. Eisenberg said on the one hand the Internet is a true marketplace of ideas, which is the basic premise of free speech in the First Amendment, while on the other hand the same technology that promotes our American values also poses a serious threat to another fundamental constitutional value, which is the right to privacy. She said on-line communication is free flowing and most everything can be easily tracked, recorded and stored by others including employers, hackers and the government. She said it is impossible for the average Internet user to know who may be participating in a chat room or monitoring their email. There is currently not much in the way of a body of law to regulate and protect privacy and the cyberspace challenges are just beginning.

Ms. Eisenberg commented that ACLU is hopeful that legislation will be formulated to protect privacy. She said although that task may be difficult, there is guidance in the Constitution, and while it does not explicitly enumerate privacy as an individual right, the Supreme Court has long held that such a right is implicit and a fundamental freedom entitled to a high degree of protection. She cited the Fourth Amendment, which addresses the right of government to interfere and the right of citizens to be free from interference by government in terms of searches and seizures. She said that although the context of that Amendment usually addresses criminal justice issues, the courts are now moving toward expanding that definition and finding that a search and seizure can be of an intangible nature, such as capturing information from the Internet or by capturing an entire computer system.

Ms. Eisenberg said the Arizona Constitution is only one of ten constitutions which has explicitly incorporated those protections, which provides in Article 2, § 8, that "No person shall be disturbed in his private affairs, or his home invaded, without authority." She commented that within the framework of the Constitution or common law when discussing privacy, the first legal analysis must always be whether there is an expectation of privacy and without that expectation, there is no enforceable right. She gave an example of the workplace on the subject of email, where it is becoming well settled that in the absence of a policy, agreement or legislation to the contrary, the employer owns the e-mail and therefore has access to it.

Ms. Eisenberg said it becomes apparent that as we discuss issues in cyberspace, the First and Fourth Amendment protections apply. She said it is also clear that the right to privacy today is recognized as applying beyond the tangible and physical intrusion envisioned by search and seizure limitations and cited particular court cases. She indicated there is a body of statutes at the federal level, which define and protect privacy and enumerated some of those. She said some of the things the ACLU considers to be essential elements of a privacy policy include:

- Web sites: Organizations and especially government agencies which have web sites should be required to openly and plainly advise users of their privacy policies. Agencies which gather information on the Internet must be required to set out in plain terms what the information will be used for, with whom it will be shared and who will have access to it. Organizations and agencies should be required to limit their use of information to that which was intended by the information provider, that is, the individual. In the private sector, providers should change their online service agreements to provide for stronger privacy protections for their customers and be required to plainly state their policies with respect to privacy.
- There must be public disclosure of all data systems which contain personal information. An individual must be provided a means to ascertain what information is being kept, for what purpose it is being used, and a means must be provided to the individual to prevent information being used for any purpose other than that for which it was provided without the individual's consent.
- Any agency creating, using or disseminating records of identifiable personal data must assure the reliability, accuracy, security and timeliness of the data, and an individual must have a means to correct or amend records with identifiable information. An agency or organization should conduct periodic risk assessments balancing the possibility or probability

of unauthorized access or disclosure against the cost of security precautions and the expected effectiveness of those precautions.

- Organizations and agencies should be required to take special precautions in using personal information regarding children including juvenile justice records. She said that Arizona, shamefully, is one of the few states that makes juvenile justice records public.
- Email presents a series of problems in protecting privacy, however, the rights of an online user of email are generally dictated by the service provider.
- Contract provisions are non-negotiable and need to be reviewed. An e-list is only as secure as the participant who has the lowest level of privacy and security.
- Government agencies must be required to be mindful that the search and seizure limitations of the Fourth Amendment and the corresponding Arizona provision prevail, and they must seek a warrant and must support it with probable cause to believe that criminal activity has taken place. Government agencies should not be allowed to go on fishing expeditions.
- There must be constitutional protection extended to e-mail and other uses of the Internet. There is a difference between stored e-mail, read e-mail and e-mail, which is still in transmission. Transmission e-mail is entitled to a higher degree of protection. Stored or unread e-mail should be treated with a higher degree of protection as well.
- While there is recognition by the industry and all advocates that encryption is the key to privacy and security of use of the Internet by the user, the federal government is moving in some quarters to require the industry to turn over its encryption keys, which should be avoided at the state level.

Ms. Eisenberg commented that the privacy debate is just beginning and she hopes Arizona will become a leader in the protection of the individual's rights to privacy in cyberspace.

Representative Wong said these issues are very important and at some point legislators will need to meet with criminal law specialists as well as with individuals from the judiciary committees. He said the Attorney General's office is working with legislators at this time to update existing criminal laws with regard to perpetrators, but there is a parallel balancing effect that also gives certain protection of due process rights to the accused.

Mr. McNulty said he is interested in the interplay between user agreements and the wiretapping laws. He said since contacts imply that nothing is confidential and one should assume that everything sent over the Internet is public, perhaps U.S. West could provide copies of e-mail of certain subscribers.

Ms. Eisenberg responded that there has been federal legislation, which addressed wiretapping by telephone, which was amended in the 1980's to include all forms of digital communication. She said on the civil side, service providers are moving towards providing more privacy, however, at a minimum they have to disclose it. She said there are some alarming instances involving digital communication over cell phones. She commented that a cell phone is a radio broadcast device and, as such, a court found that there was no privacy expectation because you are broadcasting. When the courts looked at a communication between a lawyer and his client, they found that there was no confidentiality and no privileged communication.

TAPE 3, SIDE A

Ms. Eisenberg believes it will be incumbent upon government and the industry to ensure that individuals know the risks they are taking and to attempt to minimize that risk in order to have privacy and confidentiality. She said from what she has learned, encryption is the safest way to go. Ms. Eisenberg distributed copies of her remarks (Attachment C).

Terry Trost, Assistant Director for Transaction, Privilege and use Taxes with the Arizona Department of Revenue (IRS), commented the IRS is subject to some of the strictest confidentiality laws. For example, he said if he knowingly discloses anything, he will have committed a Class 6 felony, which is a criminal act, indictable and convictable.

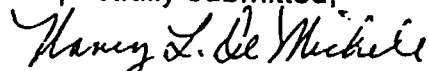
Mr. Trost commented that when administering a tax program under e-commerce, when someone wants to purchase something exempt, he needs to have enough information to know and verify that the exemption is legal and appropriate under state statutes because exempt means a product is purchased tax-free. He said beyond that he does not need to know anything further regarding a transaction. He indicated if it is a nexus situation and it is a taxable transaction and an exemption is being claimed, he needs to verify it. He said that is the only thing he would request with respect to privacy.

Dr. Lewis asked whether a form of identification is required now on any exempt transaction. Mr. Trost replied that some documentation is required to validate the fact that the purchase is eligible for the exemption under law. Dr. Lewis commented that the same process should be extended to the Internet. Mr. Trost said he agreed.

Representative Hatch-Miller announced today's meeting is the last briefing session and in two weeks a report will be available, which everyone will receive in advance. He said debate will take place on some final issues and the Committee will vote on whether or not to forward the Report to the Governor and Legislature. He thanked everyone involved and said the Committee will meet in two weeks. He announced a subcommittee will also meet on November 18 and will discuss privacy and the principles that should apply.

There being no further business, the meeting adjourned at 4:30 p.m.

Respectfully submitted,



Nancy L. DeMichele
Committee Secretary

(Tapes and attachments are on file in the Secretary of the Senate's Office.)

Hearing Room No. 109
Date: 11/17/99
Time: 2:30

MEETING OF COMMITTEE ON

INTERNET

[illegible]

Assignment A

Sen. Super

ARIZONA STATE LEGISLATURE

SEC. OFC.

STUDY COMMITTEE ON INTERNET PRIVACY, JURISDICTION, REGULATION AND TAXATION

Minutes of the Meeting
December 1, 1999 – 2:30 p.m.
Senate Appropriations Room 109

DEC 14 1999

Members Present:

Representative Jeff Hatch-Miller, Co-chair
Representative Barry Wong
Representative Ramon Valadez
Representative Barbara Leff
Dr. William E. Lewis
The Honorable Chris Bavasi
Michelle Ahlmer

Senator Scott Bundgaard, Co-chair
Senator Ken Bennett
Senator George Cunningham
Senator Harry E. Mitchell
Senator Marc Spitzer
John Kelly
Michael McNulty

Members Absent:

Representative Debora Norris
Peter Charlton

Staff:

Melodie Jones, House Majority Ways and Means Research Analyst
Jeff Kros, Senate Finance Analyst

Representative Hatch-Miller called the meeting of the Study Committee on Internet Privacy, Jurisdiction, Regulation and Taxation to order at 2:35 p.m. Attendance was noted. See attached list for other attendees (Attachment A).

OPENING REMARKS

Representative Hatch-Miller welcomed everyone and indicated the Committee has met every two weeks during the past three months, in addition to holding intense work group sessions. He announced a copy of the Final Report as distributed (Attachment B) is a combination of the work group activities and briefings assembled in a format that expresses the feelings, thoughts and concepts of the Committee. He said the Committee will discuss the report at today's meeting and decide whether or not to forward it to the Governor and Legislature.

DISCUSSION OF FINAL REPORT

Mr. McNulty commented he circulated the Report to some of the trade groups with which he shared information in the past and that he received an analysis report from Mr. Wes Hopper of the Arizona Internet Professionals Association, which Mr. McNulty

submitted for the record (Attachment C). He noted that one of the points reflecting the views of the Internet community in their analysis report is the lack of competition in the telecommunications marketplace. He pointed out an individual can go to the local department store and buy many different kinds of soap, but one cannot elect to have a particular telephone company serve a residence. Mr. McNulty suggested that on Page 8, a new Item #6 be added under Principles for Telecommunication Regulation as follows: "The State must work to remove barriers to telecommunication competition in the residential marketplace."

Senator Spitzer commented he attended a meeting in Tucson where the community expressed frustration that small businesses in the outlying and rural areas are not afforded the same telecommunication discounts based on volume and price as the concentrated large downtown businesses. He believes the term "residential" is too restrictive based on what he heard from the complaints. Mr. McNulty said he agreed with Senator Spitzer's comments.

Mr. McNulty moved that in the Final Report, Page 8, under Principles for Telecommunication Regulation, a new Number 6 be added to read: "The State must work to remove barriers to telecommunication competition." Motion carried by voice vote.

Representative Wong commended Representative Hatch-Miller for the countless hours spent on the report, but said he had some concerns with the general principles in the taxation section. He said this topic will be debated in the Legislature and State and local governments regarding actual and potential loss of tax revenues as a result of not capturing those revenues through e-commerce transactions. He noted that governments need to exercise care or this emerging industry could suffer in consumer sales, which could impact the economic development of e-commerce transactions. He indicated that Arizona has an opportunity to attract and capture e-commerce companies and that the Arizona Software Internet Association has been very active in working with various jurisdictions in cities to set up a technology oasis as a hub of activity. Representative Wong said he would like to see that expanded on a statewide basis. He said he is concerned that if the e-commerce companies are taxed, it will send a negative message to this emerging industry. He commented that the founder of the Internet was interviewed on business radio recently and remarked that at some point the founder envisions some type of taxation of e-commerce, but cautioned not to rush to judgment because the entire issue of the taxing system may have to be reviewed. Representative Wong announced he will be proposing a moratorium on State and local taxation of e-commerce activity for a period of at least five years in the next Legislative session.

Senator Bundgaard commented the consistent theme in the Final Report is that taxation should be uniform and the existing tax structure should not be dismantled. Based on that, he asked Representative Wong whether he was proposing to eliminate sales and use taxes as it pertains to Internet transactions.

Representative Wong replied that his proposal would basically be similar to the federal moratorium, and he requested staff to obtain a copy of the language at the federal level and proposes to extend that moratorium on the State level for at least a minimum period in order to give everyone an opportunity to continue to examine the new phenomenon in e-commerce retailing. He mentioned the unprecedented level of spending that will take place in this country in the future from the baby boomer aging generation and emphasized care needs to be taken to conduct accurate analysis and not to rush to judgment.

Senator Bundgaard responded he is concerned that Representative Wong's proposal perpetuates the notion that the Internet is tax free, when that is not the case because there are sales and use taxes for which individuals are responsible. He noted it is difficult for the Department of Revenue to audit the individuals who make purchases and to enforce the collection of use taxes. He said out of the forty-five states that pay a sales tax and a use tax, individuals are responsible for paying that tax, and their locality suffers if those taxes are not paid. He said he basically agrees with the taxation issue as outlined in the Final Report, which is a responsible step forward in stating that the current system we have is complex, ineffective and unenforceable. However, he emphasized it is not a tax-free zone and a solution needs to be formulated to collect those taxes. He pointed out the Final Report mentions an increasing erosion of tax revenues, however, he said there is an increase in other kinds of revenues to corporations as a result of all the retail sales. Senator Bundgaard remarked if e-commerce businesses locate in Arizona, he feels that will be good, but they should be treated the same as any other business with respect to paying sales and use taxes.

Representative Wong replied he is not advocating any new taxes at all and that the use tax should continue. He said his concern is that he does not want to add any new tax to e-commerce and believes it is important to give e-commerce industry a chance to flourish. He said Arizona is becoming more of a service economy and that the taxation issue should be reviewed as well. He remarked he has discussed the use tax with individuals in non-scientific polls, and he believes ninety percent of them do not know that there is a use tax and that they are obligated by law to pay it. He said he will propose and advance the issue of suspending and protecting e-commerce from any new forms of taxation and feels there will be ample opportunity to discuss and debate this particular issue as the session unfolds.

Senator Spitzer said because of the confusion on this issue, he would urge all the members to carefully read the Final Report, which accurately articulates the major issues. He said the problem is in devising a mechanism to collect the existing tax on sales of tangible personal property. He believes Representative Wong's proposal is self-defeating because if Arizona adopts a policy that grants an absolute preference for out-of-state and international companies selling personal property over the Internet, then under the *Land's End* decision of the Supreme Court there would not be a withholding mechanism or liability on the vendor and Arizona companies would be at a disadvantage. He feels the measure advocated by Representative Wong would have the ironic effect of hurting the Internet industry in Arizona and discouraging vendors

from locating in Arizona. He said the collection mechanism details need to be addressed, but feels the thrust of the Final Report is accurate.

Senator Cunningham commended Representative Hatch-Miller for the excellent report and offered some perspectives. He said in his home City of Tucson there is a small hardware store where the owner has been in business for 25 years. He pointed out that an individual is able to purchase a particular lawnmower for a price and pay a five-percent transaction privilege tax to the State of Arizona and a two-percent tax to the City of Tucson. He indicated you could buy that same lawnmower over the Internet and pay a similar price or possibly less. He said it makes no sense to him or the owner of the store in Tucson, who pays taxes in that community, for that owner to be placed in a competitive disadvantage with the out-of-state firm that is selling and shipping the same lawnmower over the Internet and not paying taxes.

TAPE 1 – SIDE B

Senator Cunningham commented on what he termed "whining" from the e-commerce industry when they imply that if taxes are imposed on e-commerce transactions, it will somehow retard the growth of the Internet. He believes that assertion is ludicrous which would suggest that the tens of millions of personal computers purchased by consumers would not have been purchased or acquired unless they had been exempt from paying a sales tax.

Ms. Ahlmer of the Arizona Retailers Association said that retail sales levels are a little unclear unless each company is evaluated to determine the sales generated through Internet sales. She said it is very difficult to determine because there is not a system of reporting and they generally rely on sales tax collections to assess retail sales. She noted the moratorium at the federal level has given policymakers time to look at the issue, however, she believes allowing Internet retail companies time to flourish is a dangerous and difficult position for brick-and-mortar retailers. She noted the Retailers Association has taken the position that while there are those on the Internet that would prefer not to see any taxation, it is fundamentally unfair. She referred to Mr. Brundrett of Norwood Furniture who recently testified regarding his company's position, and she also concurred with Senator Cunningham's remarks. She said it is difficult for the small upstart brick-and-mortar retailers to survive because of the increased competition and believes it is unfair to require tax collection and transmission of a bricks-and-mortar retailer that is not required of other types of e-commerce remote sellers. She voiced her concern that if a moratorium is extended at the State level, she feels that the small retailers will have additional hardships imposed on them and would like it to be handled fairly and easily.

Representative Hatch-Miller indicated if Representative Wong introduces his legislation, the discussion will continue on the taxation issue.

Mr. Kelly referred to Senator Spitzer's comments and said there has been miscommunication and misunderstanding regarding some of the issues. He noted the

obligation of paying use taxes is the same for all retailers and it becomes a territorial and administrative cost issue in collecting out-of-state taxes. He said he believes a cost benefit analysis needs to be conducted that would enable the acquisition of this revenue. He said the cost of implementing a technological collections project such as this is an enormous project and has all the elements of failure. He said the points taken regarding the impact on local retailers are correct, but he feels the solution needs to encompass uniformity, simplicity and equity.

Senator Bennett referred to Page 3, under Key Principles. Item 2, which states as follows: "The primary role of government is to preserve the integrity of the network and protect citizens." He said he was not sure what is meant by "integrity of the network," indicating it is a broad statement.

Representative Hatch-Miller replied he could not speak for the original author of that item because it came from a work group, but basically the concept and intent relates to issues of the infrastructure and its security. He said the State has a responsibility, similar to protection of highways, to protect the new roadway called the "Internet" and to make it a secure and orderly marketplace.

Senator Bennett indicated his concern derives from a possible conflict that the broad statement could generate in other portions of the Report, which he believes correctly states that the marketplace including the private sector should resolve these key issues rather than the government playing a key role. He said he would not want the wrong impression to be conveyed early in the Report and feels more clarification would be of benefit.

Senator Bennett referred to Page 19, under "Type of Tax Principles" and said Items 1, 2, 3, and 5 appear to be statements of principle, while Item 4 appears to be more of an opinion against a national sales tax and how it would affect Arizona. Therefore, he questioned whether Item 4 is a statement of principle or if it is needed at all. Representative Hatch-Miller replied that Item 4 was an attempt by the work group to clarify an original statement indicating that a national sales tax is a bad idea.

Senator Bennett replied he believes if the federal income tax was eliminated, a national sales tax would be a great idea. He said in this instance in the Report it appears to be a national sales tax that would somehow be revenue-shared back to the states to replace individual sales taxes and Arizona might not get its fair share.

Senator Bennett moved that Item 4 on Page 19 under "Type of Tax Principles" be stricken from the Report.

Ms. Ahlmer suggested perhaps it would be more clear if it stated "If any tax is assessed, it should be at the State level instead of at the national level." Senator Bennett replied that might refer to the earlier discussion implying the Internet is already a tax-free zone, which it technically is not. He noted on that same page, under "Tax Legislation Principles" Item 2 states that the Internet Tax Freedom Act deals with taxes on access

and use of the Internet, rather than the transactions being accomplished through it. He said he has supported the idea of a national sales tax to replace the federal income tax and thinks it has a lot of merit.

Representative Hatch-Miller said this document is not intended to be a statement of national sales tax policies.

Representative Leff suggested adding words as follows: "a national sales tax, in place of a state tax." Senator Bennett indicated that would solve the problem and offered a substitute motion.

Senator Bennett moved that on Page 19, Item 4, under "Type of Tax Principles" the sentence should read: "A national sales tax, in place of a state sales tax, would likely increase Arizona's current status as a net donor to other states." The remainder of Item 4 remains as is. Motion carried by voice vote.

Dr. Lewis asked to re-address Page 3, Item 2, under Key Principles, which states: "The primary role of government is to preserve the integrity of the network and protect citizens." He believes that task is probably impossible and questioned whether it should be included. He also referred to Page 3, third paragraph from the top of the page in the left-hand column, seventh line, which states: "Protection of users from fraud and to secure their privacy have been numerous and generally successful." He stated he disagrees because he does not believe they have been successful in most cases. He referred to the next sentence, which states, "Powerful alliances of key e-industry representatives are now hard at work making the Internet the safest and preferred medium of all for selling, distributing, investing – for all the purposes possible over the Internet." Dr. Lewis believes the above two sentences detract from the integrity of the Report because neither is correct.

Representative Hatch-Miller replied he would like to avoid going into rewriting too much of the whole document, but would entertain a motion to delete Item 2 under Key Principles.

Dr. Lewis moved to delete Item 2 on Page 3, under "Key Principles" which states: "The primary role of the government is to preserve the integrity of the network and protect citizens."

Senator Cunningham commented he is not willing to accept the notion that there is no role of government in protection of citizens with regard to the Internet and questioned the words "integrity of the network."

Representative Hatch-Miller responded the basic concept behind this related to security and issues of the infrastructure as a critical element of the State, which should be protected both physically and in terms of security.

Senator Cunningham commented that sometimes elected officials create unreasonable expectations for the public. He said if it states that the primary role of government is to preserve the integrity of the network, but it cannot, then that portion needs to be deleted. However, he said that protection of citizens is something that can be accomplished. He said he accepts the explanation and feels the statement should be re-worded.

Dr. Lewis commented the sentence could read: "The primary role of government is to protect its citizens," and said words could be added, to the effect "with regard to Internet activity."

Senator Bennett pointed out Item 5 on Page 3, states: "Government regulation should be employed when voluntary codes of conduct and industry self-regulation fail to provide an adequate remedy." He questioned whether the existence of Item 5 would allow the elimination of Item 2 altogether.

Representative Hatch-Miller asked Dr. Lewis to re-state his motion. Dr. Lewis restated his original motion.

Dr. Lewis moved to delete Item 2 on Page 3 under Key Principles, assuming Item 5 on Page 3 contains most of the concerns of protection.

Senator Spitzer commented he believes there is a difference between Item 2 and Item 5. He said Item 5 refers to civil issues such as the sale of securities over the Internet, however, the securities acts, laws and self-regulation already exist as part of the securities industry. He said Item 2 refers to issues of cybercom, such as Internet gambling, pornography, illegal sale of pharmaceuticals and medicine, practicing medicine without a license, and very dangerous criminal activity which violates existing law. He said Item 2 recognizes that government has a role of protecting lives and property of citizens of the State and it is accomplished through laws. He felt in this type of comprehensive document, an omission of that issue would be improper.

Senator Spitzer moved a substitute motion to Dr. Lewis' motion that Item 2, Page 3, under Key Principles should read: "It is a role of government to protect the health, lives and property of the citizens with an understanding of enforcing government statutes that may be implicated by Internet issues." Motion carried by voice vote.

CHANGE TAPE – TAPE 2, SIDE A

Senator Cunningham referred to Page 6, Item 4, under "Regulation Crime Principles" which states: "The State must further evaluate its role in regard to the sale and purchase of potentially criminal information (such as methamphetamine recipes)." He said the way it is written it appears that the State has a role in purchasing criminal information.

Senator Cunningham moved the sentence on Page 6, Item 4, under "Regulation Crime Principles" should be changed to read: "The state must further evaluate its role in regard to the sale and purchase of potential criminal information by individuals or entities." Motion carried by voice vote.

Mr. Kelly referred to Page 7, Item 4, under "Commerce Regulation Principles" which states "Software and intellectual property theft, also known as piracy, is one of the e-industry's largest threats. Especially in governmental offices, such theft should be vigorously prosecuted." He questioned whether this refers to selective enforcement in government offices only, or whether it is more generic. He said his recommendation would be to eliminate the reference to "especially in governmental offices."

Mr. Kelly moved that on Page 7, Item 4, the words "especially in governmental offices" be stricken and that the sentence should read: "Such theft should be vigorously prosecuted." Motion carried by voice vote.

Mr. McNulty referred to Page 23, Item 8, under Privacy Citizen Principles regarding unsolicited e-mail a/k/a SPAM. He believes SPAM should be criminalized as it is in five other states, however, after discussing it with Internet professionals, he said there is an aspect of SPAM that can be controlled and will make sense. He suggested at the end of Item 8 adding the clause: "however, the use of fraudulent address headers to disguise the identity of those sending SPAM email should be prohibited." He said the companies sending SPAM that cannot be found are the ones creating this problem. Mr. Kelly's proposal would not criminalize SPAM, but rather ensure that companies are not fraudulently using address headers to disguise what they are.

Ms. Ahlmer asked whether that would have the same effect of keeping pornography from being sent, if that type of fraudulent header is used. Mr. McNulty replied that ninety-five percent of the pornography advertisements sent as SPAM have disguised headers and nothing can be done because they cannot be located. Dr. Lewis indicated this practice is difficult to eliminate, but the frequency could be reduced. Mr. McNulty commented if it is reduced, that will be better than not at all.

Mr. Kelly remarked discussion took place in the subcommittee meetings regarding the application of rules to the virtual world that we apply to the non-virtual world and indicated almost every day he receives SPAM in his mail box and has no idea of the identify of the senders of that SPAM. He wondered if the law regarding that kind of deceptive practice through the mails could be similarly applied in this instance. Mr. McNulty replied that the United States Federal Trade Commission has authority to penalize fraudulent advertisements and he said it is his position that the State could make a similar statement on this subject.

Mr. McNulty moved that on Page 23, at the end of Item 8, strike the "period," insert a "semi-colon" with the words: "however, the use of fraudulent address email headers to disguise the identity of those sending SPAM emails should be prohibited." Motion carried by voice vote.

Representative Wong asked whether the Committee will be voting on each section separately or the Report as a whole. Representative Hatch-Miller replied the vote will be taken on the Report as a whole. Representative Wong indicated he would like to suggest that the Committee vote on the Taxation section separately.

Senator Cunningham commented that usually a vote is taken on an entire document, similar to the way a vote is taken on an entire bill, and to the extent a member has reservations, he or she files a minority report. He said he would prefer the Committee handle the voting in this manner. Representative Hatch-Miller responded he agrees with Senator Cunningham's recommendation and the Committee will vote on the entire document, but would welcome a minority report, if Representative Wong would like to submit one.

The Honorable Bavasi extended his congratulations to Representative Hatch-Miller for a fine job and asked whether there were any substantive changes in the Final Report distributed today as opposed to the draft sent to the Committee previously. Representative Hatch-Miller replied there are no substantive changes from the draft, although improvements were made today. He extended his appreciation for everyone's involvement and willingness to look at the detailed level of the Report. He said the next step is for the Committee to vote on whether to forward the Final Report to the Governor and the Legislature.

Representative Wong asked if it would be a voice vote or a roll call vote. Representative Hatch-Miller replied it will be a voice vote unless there is division on that method of voting. Representative Wong responded if a voice vote was going to be taken, he wished to make another comment for the record. He said there was discussion on taxation, which is clearly a very emotional issue to many people and there are arguments on both sides and will continue to be. He said he wished to respond to the comment made earlier regarding "whining" by the e-commerce industry with regard to taxation. He said in his opinion the "whining" is the right of an industry to voice its concern when it sees the heavy hand of government coming down with an issue of taxation. He believes this type of comment from industry is expected and should be welcomed, when government takes action that may be detrimental to an emerging industry. He said he feels that government should be encouraging innovation and that e-commerce is clearly a unique innovation in this country. He said he further believes government should tread very carefully before it decides to tax or regulate or somehow impose the will of government over a private entity or person or business. He added there will continue to be discussion on this issue, but the Legislature needs to look at the economic impact to the State. He said comments will be forthcoming from all sectors of the economy as this debate unfolds. Representative Wong stated that he will

support the Final Report because he believes there is more positive than negative substance. He commended Representative Hatch-Miller for his countless hours in bringing the study to fruition, but he stated he will be dissenting on the taxation part of the Report.

Dr. Lewis moved for acceptance of the Final Report as modified to be forwarded to the Governor, the Speaker of the House, the President of the Senate and fellow Legislators. Motion carried by voice vote.

Senator Cunningham extended his congratulations to Representative Hatch-Miller for a fine job. Representative Hatch-Miller thanked Senator Cunningham and publicly thanked Melodie Jones, House Majority Ways and Means Research Analyst, who spent countless days, evenings and weekends working to help generate the Report.

Senator Mitchell congratulated Representative Hatch-Miller for guiding the Committee through the enlightening process in dealing with a major policy issue and said he appreciated the opportunity to participate with the Committee. Representative Hatch-Miller extended his thanks to Senator Mitchell. Senator Cunningham and Representative Leff also voiced their congratulations and thanks to Representative Hatch-Miller for a great job.

Representative Hatch-Miller thanked everyone and said he was proud of the Committee, but indicated the work was not finished. He said the Committee would get together sometime in January and watch as things unfold over the course of the next Legislative session. He said although there will not be an official meeting, the group would stay in touch and work together to discuss legislation for the following year.

There being no further business, the meeting adjourned at 3:45 p.m.

Respectfully submitted,



Nancy L. DeMichele
Committee Secretary

(Tapes and attachments are on file in the Secretary of the Senate's Office)

Time: 7:30 AM

Internet Privacy vs. Online Advertising Taxation

Attachment A

Appendix III:

List of Submitted Documents

(Copies of submitted documents may be obtained by contacting
House Research Staff)

List of Documents Presented to the Committee

1. Chairman Hatch-Miller Presentation – Public Internet Policy
2. Committee Legislation & Mandate -- Staff Presentation
3. Internet Briefing Packet – Staff Presentation
4. State Strategic Plan for Information Technology
5. "Electronic Signature In Arizona – Where Do We Go from Here?"
6. "Statewide Information Management Policy"
7. "Information Security in State Government Information Technology"
8. "Internet Security: An Industry Perspective"
9. Prepared Statement by Lee Lane, Statewide Security Manager, Arizona Department of Administration
10. Comparative Chart on State Computer Crime Statutes – Staff Presentation
11. Court Decisions on Jurisdiction – Staff Presentation
12. Prepared Statement by Senator John McCain
13. Prepared Statement by Dr. Janice Brundage
14. Prepared Statement by Llyn A. Lloyd, Executive Director of Arizona State Board of Pharmacy
15. Prepared Statement by Paul Walker, Arizona Department of Gaming
16. Prepared Statement by Eleanor Eisenberg, Arizona Civil Liberties Union
17. Presentation Deanna Conn, Streigh Lang
18. Presentation Carder Hunt, City of Scottsdale
19. Prepared Statement, John Badal, Arizona Competitive Telecommunications Coalition
20. Presentation by Mary Ellen Gleason, U.S. West
21. Prepared Statement by Lyle Williamson, MCI WorldCom
22. Paper by Dean Andal, Vice Chairman of the California State Board of Equalization & A member of the US Advisory Commission on Electronic Commerce
23. Paper by Orson Swindle, member of the Federal Trade Commission
24. National Home Furnishings Association Washington Report, October 1999
25. Presentation by James R. Eads, Partner with Ernst & Young LLP
26. "The Sky is Not Falling" – Ernst & Young

Appendix IV:

Example of Taxation Methodology

Example of Taxation Methodology

One potentially suitable methodology in the realm of electronic transactions is to relieve the seller from the burden of collection altogether through the use of a third party independent of both buy and seller. Sales taxes for various destinations are already computed automatically by software. Instead of this tax information being generated by and used by the retailer, a payment processor or clearinghouse would seamlessly provide notification of the tax amount for use by a merchant's shopping program. Upon approval of the purchase, the third party would transfer the tax amount to the appropriate governmental account and simultaneously transmit the purchase price to the retailer's account(s). The retailer need never see, account for, nor report the tax amount.

Retailers would establish a special credit card account for receipt of cash and check payments. At the end of a month the merchant's credit card processor would submit one integrated bill for the total taxes.

Such a system follows Congressional wishes for a system that is fair, simple and uniform. It responds to the Supreme Court prohibition of forcing vendors with no substantial nexus to collect a jurisdiction's use tax.¹ It allows local jurisdictions to determine taxes on goods purchased by its own citizens. It even deals with international sales since the purchase is taxed locally and need not know where the retailer is located.

In opposition to the imposition of a national sales tax on remote sales, Arizona should join in a compact with the other forty-nine states, adopting a uniform system for assessing and collecting sales and use taxes on the purchase of items from remote vendors. Such a system would provide uniform definitions or classifications of goods and services among the states. In addition, it would address uniform treatments of bad debts, returns, and charge-backs related to sales and use taxes.

¹ *Quill v. North Dakota*, 504 U.S. 298 (1992)

Appendix V:

Reference to Selected Bibliography

(Agendas, minutes of sessions and additional support materials can be accessed online at WWW.azhousetv.org)

ARIZONA STATE LEGISLATURE

Joint Interim Meeting Notice

Open to the Public

SUBCOMMITTEE ON PRIVACY OF THE STUDY COMMITTEE ON INTERNET PRIVACY, JURISDICTION, REGULATION AND TAXATION

DATE: THURSDAY, NOVEMBER 18, 1999

TIME: 9:00 a.m. - 12:00 p.m.

PLACE: HOUSE BASEMENT ROOM 038

SUBJECT: PRIVACY

Discussion/Developing Principle Statements

MEMBERS:

Representative Debra Norris
John Kelly
Michael McNulty

Senator George Cunningham
William E. Lewis

c8
11/16/1999

People with disabilities may request reasonable accommodations such as interpreters, alternative formats, or assistance with physical accessibility. If you require accommodations, please contact the Chief Clerk's Office at 602-542-3032, (TDD) 542-6241.